IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

IDAHO POWER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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* A copy of the Tax Court's Memorandum Findings of Fact and Opinion was filed as Appendix A to the Petition (Pet. 10-19). The opinion of the Court of Appeals and that court's Order for Amendment of Opinion was reproduced as Appendix B to the Petition (Pet. 20-37). The Court of Appeals' Judgment was reproduced as Appendix C to the Petition (Pet. 38).

TAX COURT OF THE UNITED STATES

General Docket

Docket No. 4012-67

IDAHO POWER COMPANY
M. M. Ilch, Treas.
1220 Idaho St.
Boise, Idaho 83701
PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

APPEARANCES FOR PETITIONER:

Norton Kern and Lawrence C. Wilson (Reid & Priest), Two Rector St., New York, New York 10006.

RELEVANT DOCKET ENTRIES

DATE	FILINGS AND PROCEEDINGS
Aug. 9, 1967	PETITION FILED: FEE PAID Aug. 9, 1967.
	* * * *
Sept. 28, 1967	ANSWER filed by Respondent.
	* * * *
April 1, 1969	TRIAL at Portland, Oregon before Judge Scott.
	Stipulation of facts, together with joint Exhibits—FILED.
	ORIG. BRIEFS DUE: July 30, 1969.
	REPLY BRIEFS DUE: August 29, 1969
	SUBMITTED TO THE COURT

RELEVANT DOCKET ENTRIES

DATE	FILINGS AND PROCEEDINGS
Apr. 18, 1969	TRANSCRIPT of trial proceedings Apr. 1, 1969, received.
May 27, 1969	STIPULATION of Correction of Report of Trial Proceedings filed by the parties.
July 21, 1969	ORIGINAL BRIEF for Petitioner. (20 P. Copies).
July 30, 1969	ORIGINAL BRIEF for Respondent filed.
Aug. 28, 1969	REPLY BRIEF for Petitioner filed. (20 P. Copies).
Aug. 29, 1969	REPLY BRIEF for Respondent filed.
April 13, 1970	MEMORANDUM FINDINGS OF FACT AND OPINION filed Judge Scott Decision will be entered for the respondent.
April 23, 1970	DECISION entered Judge Scott.
	APPELLATE PROCEEDINGS
June 29, 1970	MOTION to fix bond filed by Petr.
June 29, 1970	ORDER fixing amount of bond at $192,637.43.
July 20, 1970	Surety bond in the amount of $192,637.43 with General Insurance Co. of America, as surety, approved and ordered filed.
July 20, 1970	NOTICE of Appeal to U.S.C.A., 9th Cir., filed by Petr.
July 20, 1970	NOTICE of filing with copy of notice of appeal sent to K. Martin Worthy, Chief Counsel.
July 20, 1970	NOTICE, to parties, of assembling and date for transmission of the record.

IN THE COURT OF APPEALS FOR THE NINTH CIRCUIT

RELEVANT DOCKET ENTRIES

DATE	FILINGS AND PROCEEDINGS
Aug. 28, 1970	FILED CERTIFIED CERT TRANSC OF RECORD ON APPEAL IN 2 VOLS: VOL. 1, PLEADINGS, VOL. 2, RPTR's TRANSC., ORIGS ONLY. FILED ORIG EXHIBITS IN LPS * * * DOCKET FEE PAID, CAUSE DOCKETED & ENTERED APPEARANCES OF COUNSEL.
Oct. 2, 1970	FILED TWO ADD'L COPIES OF VOLS. I & II OF RECORD: 85 pp.
Oct. 2, 1970	BRIEF TIME SET Nov. 12.
Dec. 7, 1970	FILED 26 APPELLANTS BRIEFS.
Feb. 1, 1971	Recvd. prae & entered appearance of counsel for appellee-CIR.
Feb. 1, 1971	FILED 25 APPELLEES BRIEFS.
Feb. 19, 1971	FILED 25 APPELLANTS REPLY BRIEFS.
Sept. 26, 1971	Recvd orig & 3 Applt's add'l citations. ps (T Cy McGov).
Oct. 10, 1972	ARGUED AND SUBMITTED BEFORE TRASK, CHOY, C.J.J., WALTER T. MC GOVERN, D.J., SEATTLE, WASHINGTON.
Apr. 10, 1973	ORDERED OPINION (TRASK) FILED & JUDG TO BE FILED & ENTD (jn).
Apr. 10, 1973	Filed opinion—Reversed (Amended by order 4/30/73).
Apr. 10, 1973	Filed & Entered Judgment (jn).
Apr. 30, 1973	Filed order (T, Cy, McGovern) amending opinion filed 4/10/73, by adding new paragraph to page 7 of slip opinion. (s)

RELEVANT DOCKET ENTRIES

DATE	FILINGS AND PROCEEDINGS
May 1, 1973	Issued judgment to Clerk, Txx Ct.
July 16, 1973	Recvd. copy of SC letter dated 7/12 re: Justice Douglas extending time to file pet for writ of cert to and including August 8, 1973.
Aug. 14, 1973	Recvd. SC notice re filing pet for cert. 8/8 SC# 73-263. aba.

TAX COURT OF THE UNITED STATES

Docket No. 4012-67

IDAHO POWER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (service symbols Ap:P:AA:HH 90-D:VEV) dated May 19, 1967, and as a basis of its proceedings alleges as follows:

1. The petitioner is a corporation organized under the laws of the State of Maine with its principal office at 1220 Idaho Street, Boise, Idaho. The returns for the years here involved were filed with the District Director of Internal Revenue, Boise, Idaho.

2. The notice of deficiency (a copy of which is attached hereto and marked Exhibit A) was mailed to the petitioner on May 19, 1967.

3. The deficiencies as determined by the Commissioner are in income taxes and are in the amounts of $73,023.47 and $50,342.21 for the years 1962 and 1963, respectively. The full amounts of the deficiencies listed above for the years 1962 and 1963 are in dispute, and in addition, petitioner asserts its claim to any refund, together with interest as allowed by law, to which it may be entitled for such years upon decision in this case.

4. The determination of tax set forth in the said notice of deficiency is based upon the following error:

(a) The Commissioner erroneously disallowed a part of the depreciation deductions on mobile transportation and power operated equipment and on communications equipment owned and operated by the petitioner, in the

amounts of $143,763.12 and $106,797.45, for the years 1962 and 1963, respectively.

5. The facts upon which the petitioner relies as the basis of this case are as follows:

(a) Petitioner is a public utility engaged in the business of production, transmission, distribution and sale of electrical energy. Petitioner employs the accrual method of accounting and its taxable year coincides with the calendar year.

(b) Petitioner for each of the years here involved owned mobile transportation and power operated equipment and communications equipment and deducted in its tax returns as filed depreciation in respect of such equipment.

(c) The mobile transportation and power operated equipment owned by petitioner during the years 1962 and 1963 included passenger cars, pickup trucks, light trucks, medium trucks, heavy trucks, cranes, tractors, pole diggers and similar equipment. This equipment was used in connection with operational, maintenance and construction activities. This equipment was depreciated by petitioner under the declining balance method of depreciation.

(d) The communications equipment here involved is radios for general use in connection with operational, maintenance and construction activities. A portion of such equipment has been depreciated under the straight line method. The remainder has been depreciated under the declining balance method.

(e) The petitioners, during the years 1962 and 1963 in the ordinary course of its business, constructed properties for use by it in its business. Such construction has been undertaken either with petitioner's own employee personnel or by construction contracts performed by others. Petitioner's mobile transportation and power operated equipment and communications equipment have been used in part in the construction work carried out by its employees.

(f) The Commissioner disallowed and capitalized the deductions for depreciation on petitioner's mobile trans-

portation and power operated equipment and communications equipment to the extent that the Commissioner determined that such equipment was used in the construction of capital assets. The Commissioner then allowed a deduction on the amounts so capitalized over the useful life of the properties constructed. The adjustments made by the Commissioner are as follows:

Year	Depreciation Disallowed and Capitalized	Depreciation Allowed on Depreciation Capitalized	Net Depreciation Adjustment
1962	$143,763.12	$3,333.37	$140,429.75
1963	$106,797.45	$9,985.50	$ 96,811.95

(g) The depreciation deductions applicable to the mobile transportation and power operated equipment and communications equipment owned by petitioner were claimed by and are properly allowable to petitioner as deductions in its corporation income tax returns filed for the respective years, under the authority of the provisions of section 167 of the Internal Revenue Code of 1954. The Commissioner has erroneously disallowed a part of said deduction.

WHEREFORE, the petitioner prays that this Court may try the case and determine that no deficiencies are due from the petitioner for the years here involved, and in addition grant the petitioner any and all further relief that it may be entitled to in the premises including any refunds, together with interest thereon as allowed by law, to which petitioner may be entitled upon decision of this case.

/s/ Norton Kern
NORTON KERN

/s/ Lawrence C. Wilson
LAWRENCE C. WILSON
Office and P. O. Address
Reid & Priest
Two Rector Street
New York, New York 10006

STATE OF IDAHO)
) ss.:
COUNTY OF ADA)

M. M. Ilch, being duly sworn, says that he is Treasurer of Idaho Power Company, above-named, and that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein, and that the statements contained therein are true.

/s/ M. M. Ilch
Treasurer

Subscribed and sworn to before me this 2 day of August, 1967

/s/ J. Lewis

Notary Public in and for the State of Idaho, residing at Boise, Idaho. My Commission expires October 7, 1969.

[Exhibits Omitted in Printing]

TAX COURT OF THE UNITED STATES

Docket No. 4012-67

IDAHO POWER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ANSWER

THE RESPONDENT, in answer to the petition filed in above-entitled case, admits and denies as follows:

1, 2 and 3. Admits the allegations in paragraphs 1, 2 and 3 of the petition.

4. (a) Denies that respondent erred as alleged in paragraph 4(a) of the petition.

5. (a), (b), (c) and (d). Admits the allegations in paragraph 5(a), (b), (c) and (d) of the petition.

(e) Admits the allegations in paragraph 5(e) of the petition, except that it is denied that the construction of the properties by the petitioner was undertaken in the ordinary course of its business.

(f) Admits the allegations in paragraph 5(f) of the petition.

(g) Denies the allegation in paragraph 5(g) of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiencies determined by the respondent be in all respects approved.

/s/ Lester R. Uretz, JDP
LESTER R. URETZ
Chief Counsel,
Internal Revenue Service.

OF COUNSEL:

MELVIN L. SEARS,
Regional Counsel,

JOHN D. PICCO,
Staff Assistant to
Regional Counsel,
Internal Revenue Service,
1101 Sixth & Lenora Building,
Seattle, Washington 98121.

TAX COURT OF THE UNITED STATES

Docket No. 4012-67

[Filed April 1, 1969]

IDAHO POWER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto by their respective counsels that the facts hereinafter stated shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce upon the trial of this action any other or further evidence not inconsistent with the facts herein stipulated and further reserving to either party the right to object to any fact herein stipulated on the ground that such fact is irrelevant or immaterial.

(1) The petitioner was incorporated under the laws of the State of Maine on May 6, 1915. Petitioner is a public utility engaged in the production, transmission, distribution and sale of electric energy with its principal place of business at the time of filing the petition with the Court located in Boise, Idaho.

(2) At all times material herein the petitioner maintained its books of account and filed its federal income tax returns on the calendar year basis.

(3) At all times material herein the petitioner employed the accrual method of accounting with respect to its books of account and in the filing of its federal income tax returns.

(4) By statutory notice of deficiency mailed to the petitioner on May 19, 1967 the respondent determined deficiencies in the petitioner's income tax for the years 1962 and 1963 in the amounts of $73,023.47 and $50,342.21, respectively.

(5) The petitioner claimed in its tax returns as filed or adjusted total depreciation deductions for the years 1962 and 1963 in the amounts of $9,379,380.47 and $11,354,885.50, respectively.

(6) During each of the years 1962 and 1963 the petitioner owned automotive transportation equipment used in its business. Communication equipment, such as radios, was affixed to the transportation equipment and used in the operation of such transportation equipment. Petitioner used such transportation equipment in part for operation and maintenance and in part for the construction of additional operating properties having a useful life of more than one year. In its books of account the petitioner charged the depreciation on the transportation equipment to the extent used in construction to the capital assets so constructed either directly or through clearing accounts in accordance with accounting procedures by the Federal Power Commission which have been adopted by the Idaho Public Utilities Commission; see Exhibit 1-A. The depreciation so capitalized on petitioner's books of account for the years 1962 and 1963 amounted to $150,047.42 and $130,523.99, respectively.

(7) In computing depreciation for tax purposes the petitioner deducted depreciation on all transportation equipment including depreciation on transportation equipment used in construction. Such equipment was depreciated over a composite life of 10 years. Petitioner depreciated all of its automotive transportation equipment whether or not used in construction under the straight line and declining balance methods of depreciation.

(8) The petitioner deducted depreciation for tax purposes with respect to the transportation equipment owned by it including depreciation on such equipment used in construction for the years 1962 and 1963 in the aggregate amounts of $297,276.92 and $309,288.89, respectively, computed as follows:

	Under the straight line method	Under the declining balance method	Total
1962			
Transportation equipment:			
a. a/c 392—transportation		$239,230.97	$239,230.97
b. a/c 396—power operated		41,529.69	41,529.69
c. a/c 397—radios	$5,836.89	10,679.37	16,516.26
	$5,836.89	$291,440.03	$297,276.92
1963			
Transportation equipment:			
a. a/c 392—transportation		$241,984.19	$241,984.19
b. a/c 396—power operated		26,871.56	26,871.56
c. a/c 397—radios	$13,728.93	26,704.21	40,433.14
	$13,728.93	$295,559.96	$309,288.89

(9) For the years 1962 and 1963 the Commissioner of Internal Revenue disallowed and capitalized the deduction for depreciation on taxpayer's transportation equipment to the extent that such equipment was used in the construction of capital assets and allowed a deduction for depreciation on the amounts so capitalized over the useful life of the property constructed. The property so constructed was primarily transmission and distribution facilities with a useful life of 30 years or longer. The adjustments made by the Commissioner are as follows:

Depreciation on transportation equipment disallowed and capitalized:

Description	Depreciation claimed on return	Per cent to be capitalized	Amount to be capitalized
1962			
Straight line:			
a. a/c 397—radios	$ 5,836.89	48.36%	$ 2,822.72
			$ 2,822.72
Declining balance:			
a. a/c 392—transportation	239,280.97	48.36%	115,692.10
b. a/c 396—power operated	41,529.69	48.36%	20,083.76
c. a/c 397—radios	10,679.37	48.36%	5,164.54
			140,940.40
			$143,763.12
1963			
Straight line:			
a. a/c 397—radios	$ 13,728.93	34.53%	$ 4,740.60
			$ 4,740.60
Declining Balance:			
a. a/c 392—transportation	241,984.19	34.53%	83,557.14
b. a/c 396—power operated	26,871.56	34.53%	9,278.75
c. a/c 397—radios	26,704.21	34.53%	9,220.96
			102,056.85
			$106,797.45

Less depreciation allowable on depreciation capitalized:

	1962 Additions 1962	1962 Additions 1963	1963 Additions
Sum of year-digits properties:			
Average balance of depreciation capitalized during year less average balance of retirements	$ 977.75	$ 1,941.42	$ 540.78
Composite depreciation rate allowable	2.7077%	3.6349%	3.6349%
Depreciation deduction allowable on capitalized depreciation	$ 26.48	$ 70.57	$ 19.66
Declining balance properties:			
Average balance of depreciation capitalized during year less average balance of retirements	$68,454.39	$134,899.26	$51,694.80
Composite depreciation rate allowable	4.8308%	5.3031%	5.3031%
Depreciation deduction allowable on capitalized depreciation	$ 3,306.89	$ 7,153.84	$ 2,741.43

Summary

Taxable year	Total depreciation on transportation equipment disallowed and capitalized	Depreciation allowed on depreciation capitalized	Net amount disallowed
1962	$143,763.12	$ 3,333.37	$140,429.75
1963	106,797.45	9,985.50	96,811.95

(10) If it is determined that the depreciation sustained on the transportation equipment owned by petitioner to the extent used in the construction of capital assets is not an allowable deduction as such but should be capitalized and deductions for depreciation recovered over the useful life of the assets constructed as herein

maintained by respondent then it is stipulated that the adjustments made by the Commissioner as set forth in paragraph (9) of this stipulation of facts are correct. If, however, it is determined that depreciation on transportation equipment used in the construction of capital assets should not have been capitalized for tax purposes then it is stipulated that respondent's adjustments with respect thereto as set forth in the statutory notice of deficiency and paragraph (9) of this stipulation of facts should be reversed.

(11) The petitioner engages in the construction of additions to its property. Such construction work has been carried on either with petitioner's own employee personnel or through construction contracts performed by others on behalf of petitioner or by a combination of both. The approximate gross amounts of property constructed by the petitioner and by others as added each year to petitioner's property account for the years 1961 through 1963 are as follows:

Year	Gross Additions	Amount Constructed by Petitioner	Amount Constructed by Others Under Contract	Purchased Equipment
1961	$65,407,029.28	$14,609,896.38	$41,262,380.48	$ 9,534,752.42
1962	8,235,640.22	7,139,940.72	314,790.45	780,709.05
1963	5,988,139.56	5,642,342.79	115,792.63	230,004.14

For more than twenty years, petitioner has constructed additions to its properties by its own employees and by others under contract with petitioner. The additions so constructed were primarily transmission and distribution facilities.

(12) The types of automotive transportation equipment owned by the petitioner during the years 1962 and 1963 included passenger cars, pickup trucks, light trucks, medium trucks, heavy trucks, power operated equipment and trailers.

(13) The usage of the respective classes of petitioner's automotive transportation equipment during the years 1962 and 1963 and up to the present time is as follows:

Passenger cars:

Petitioner owns and operates a fleet of passenger cars ranging from large passenger cars to compacts. They are used to transport petitioner's personnel in the performance of their duties with respect to operation, maintenance and construction. The operating expenses for those vehicles used by management, certain supervisors, the sales department and in customer accounting and collections are all charged to operating expenses. The operating expenses for those vehicles used by superintendents, certain supervisors, engineers and their assistants are charged to the various functional activities in proportion to the miles operated for each purpose. Construction superintendents and engineers engaged entirely in construction charge the automobile operating expense to each project according to the number of miles the vehicle was operated for construction only.

Pickup trucks:

Petitioner owns and operates a fleet of trucks of less than one ton capacity that are used to transport employees engaged in various operational, maintenance and construction activities and to transport limited amounts of materials utilized in those same functions. They also serve as mobile tool boxes and work bases. Some pickups have no special equipment or special bodies and some are equipped with accessories and special bodies for use in specialized activities such as appliance servicing, meter maintenance and communication equipment operation and maintenance. The operating expenses for these trucks are charged to operation, maintenance and construction on the basis of miles operated for each purpose.

Light trucks:

Trucks of from one to two tons capacity are included in this group. They consist of four wheel drive power wagons, small line trucks, one ton pickups and flat beds. They are used largely in opera-

tion, maintenance and construction activities. The cost of their operation is charged to the various functions on the basis of hours used. Those trucks in this group classed as line trucks have special bodies and equipment.

Medium and heavy trucks:

The equipment in this group consists of all trucks 2½ tons and over, buses and traction units used to pull large trailers. There are large line trucks that are equipped with line bodies, winches and special hydraulic equipment for line construction, trucks with special tanks for transporting fish, trucks with hydraulic hoists for raising workmen to the line level, trucks with beds and hoists used for loading and transporting material, and trucks built as traction units for pulling large trailers. The operating expenses on these units are charged on the basis of hours of use. They are used in maintenance and construction. Any of these units can be and are used for any of these purposes.

Power operated equipment and trailers:

Power operated equipment covers such items as cranes, tractors, road graders, hole diggers, backhoes, air compressors and conductor tensioning equipment. Trailers range from two wheel pole trailers to multiwheel low bed trailers of 65 ton capacity which are pulled by special traction units. As in the case of trucks the units included in this category have their costs charged to the different functions on the basis of hours used. Also similar to trucks, all of these units are used in maintenance and construction activities.

(14) To the extent used in construction, all costs of operating and maintaining transportation equipment except pension contributions, social security taxes, motor vehicle taxes and depreciation were capitalized by petitioner for tax purposes. The Commissioner's position is that depreciation on all transportation equipment used in construction should be capitalized. The petitioner's

position is that such depreciation is currently deductible. There is no controversy as to the current deduction of pension contributions, social security taxes and motor vehicle taxes.

(15) The costs of construction as prescribed by the Federal Power Commission are listed and described in sections 3 and 4 on pages 8 through 10 of the Federal Power Commission Uniform System of Accounts for Public Utilities and Licenses (which includes Idaho Power Company) as applicable to the years 1962 and 1963, herein attached as Exhibit 1-A. The allocation to capital cost of depreciation on transportation equipment used in construction is set forth in account 403 on page 63 of Exhibit 1-A.

(16) Attached hereto as Exhibits 2-B, 3-C and 4-D are copies of petitioner's tax return for 1962, petitioner's amended return for 1962 and petitioner's tax return for 1963, respectively.

Dated: March 31, 1969

/s/ Norton Kern
NORTON KERN
Counsel for Petitioner

/s/ Richard M. Hahn, JDP
RICHARD M. HAHN
Acting Chief Counsel
Internal Revenue Service

[Exhibits Omitted in Printing]

Docket No. 4012-67

IDAHO POWER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

United States District Courtroom,
United States Courthouse
Portland, Oregon,

Tuesday, April 1, 1969.

Met, pursuant to notice, at 11:50 o'clock a.m.

BEFORE:

HONORABLE IRENE F. SCOTT, Judge.

APPEARANCES:

F. NORTON KERN, of the firm of Reid & Priest, Two Rector Street, New York, New York 10006. appearing on behalf of Petitioner.

JOHN D. PICCO, 820 Multnomah Building, Portland, Oregon 97204, appearing on behalf of Respondent.

• • • •

[18] JAMES F. SERVIS

was called as a witness on behalf of Petitioner and, having been first duly sworn, testified as follows:

THE CLERK: For the record, may we have your name.

THE WITNESS: James F. Servis, S-e-r-v-i-s.

THE CLERK: And your address, please.

THE WITNESS: It is 2810 Clark Street, Boise, Idaho, 83705.

DIRECT EXAMINATION

BY MR. KERN:

Q. By whom are you employed, Mr. Servis?

A. Idaho Power Company.

[19] Q. What is your position with Idaho Power Company?

A. I am now superintendent of engineering and construction.

Q. How long have you been employed by Idaho Power Company?

A. Thirty-five and a half years.

Q. Would you be kind enough to give us a brief resumé of the positions that you held with Idaho Power Company and the kinds of work you did in each position?

A. While I was going to college, I worked on construction crews during the summer and, after graduation, I worked on a construction job in the State of Nevada. I went from there—

Q. (Interrupting) May I interrupt. What year did you first go to work for Idaho Power Company while you were going to school?

A. In 1929.

Q. You continued in school for how long?

A. I graduated in '33.

Q. Please proceed.

A. In the fall of '33, I worked on the transmission line, going from there into power plant work for two years, thence into the drafting department, general office in Boise, for a year, moving into the engineering department and working from there into supervisor of mobile construction crews, mobile line, [20] that is, and until 1961, at which time I was made superintendent of construction and, as of last September, was made superintendent of engineering and construction.

Q. In what year were you first placed in charge of construction for the Idaho Power Company?

A. In 1944.

Q. Are you a registered engineer?

A. I am.

Q. In what states?

A. Idaho and Oregon.

Q. In your present position, are you in charge of the construction activities of Idaho Power Company?

A. I am in charge of all the construction with the exception of power plant construction.

Q. Does Idaho Power Company use its own men and employees to construct facilities?

A. We do.

Q. For how long has Idaho Power Company constructed its own facilities?

A. Well, during the summer vacations in 1929, I worked on a construction crew building distribution lines at that time. As far as I know, we had construction crews in Idaho Power Company since it was formed in 1916.

Q. Since you were placed in charge of construction in 1944, has Idaho Power Company constructed its own facilities [21] in each of those years?

A. Yes, we have.

Q. What kinds of facilities does Idaho Power Company construct for itself?

A. Transmission lines, transmission switching stations, distribution lines, distribution stations, and connected facilities such as roads, timber turning and so forth.

Q. Has Idaho Power Company constructed facilities of this type for itself in each of the years since you have been in charge of construction?

A. We have.

Q. Is Idaho Power Company still constructing facilities of this type for itself?

A. We do.

Q. Approximately how many men do you have or have you had engaged in the construction facilities for Idaho Power Company over the years?

A. The present time we have 140 employees who are working on construction. We have had as high as 300 heavy construction years.

Q. How few would you say that you have had involved?

A. I would say, at the present time, we are as low as we have been for a number of years.

Q. For what reason or reasons does Idaho Power Company construct its own facilities?

[22] A. We feel that we actually get a better constructed facility with our own force, at a lesser cost than going outside. When we got into this business in our area, at least, these contractors weren't available. I am going back to 1944, during World War II.

Q. Are contractors available at the present time?

A. Much more readily now.

Q. But you still continue to construct?

A. We still do a lot of our own work.

Q. How many miles of transmission line does Idaho Power Company have?

A. At the present time, we have over 4,000 miles of transmission line.

Q. How many miles of transmission, or of distribution facilities?

A. Better than 14,000.

Q. Could you state for us approximately what proportion of these facilities you believe that Idaho Power Company has constructed for itself?

A. I would say at least 75 per cent.

Q. Does Idaho Power Company use mobile transportation equipment in constructing its—

A. (Interrupting) We do.

Q. What types of equipment do you use?

A. Dispatching of cars, pickups, light trucks, heavy [23] trucks, power-operated equipment, trailers—

Q. (Interrupting) Is this equipment used for purposes other than construction of Idaho Power's own facilities?

A. At times.

Q. For what other purposes is it used?

A. It is used in emergencies, maintenance, repair work, storm damage, the moving of heavy transformers from a substation into the repair shop in Boise.

Q. Is it used for operations?

A. It is used for operations very seldom, that is, the mobile equipment.

Q. Are the automobiles used for operations?

A. Yes.

Q. The truck occasionally, are the trucks used for operations?

A. Your heavy trucks normally not. Your pickups would be out on operations on divisional work, not on the heavy construction.

Q. Is this equipment also used for maintenance?

A. Yes.

Q. Do you anticipate that Idaho Power Company will continue to construct its own facilities in the future?

A. I do.

Q. Will the types of facilities so constructed continue to be in the nature of transmission and distribution facili- [24] ties?

A. I would say that we would carry on about like we are at the present time, with the exception of going to extra high transmission lines where we get into 500 kv. The equipment there is considerably larger than we have at the present time and whether we would carry into that is not probable right now.

Q. As to distribution facilities, do you believe you will continue—

A. (Interrupting) We will continue that. And our transmission substations and distribution service stations we have constructed ever since I have been with the company, 100 per cent.

MR. KERN: I have no further questions.

Your Honor, Mr. Picco has just asked me if he may go beyond the scope of direct examination in his cross-examination. Well, I have no real knowledge as to the extent of his cross-examination. In general, I have no objection to his going beyond the scope. If something comes up, I will reserve and would like to object at that time.

THE COURT: And The Court will rule on it when it comes up.

This is the normal recess time. If you think it will be 15 minutes, we could go on and then recess until 2:30.

MR. PICCO: If Your Honor please, I think in 15 [25] minutes we may be done.

THE COURT: That is what I thought, and it would

save Mr. Kern and his witness from having to return, so we will do that, then.

MR. PICCO: Yes.

CROSS-EXAMINATION

BY MR. PICCO:

Q. Mr. Servis, part of the construction is being performed by others under contract, isn't that true?

A. Partly.

Q. Does the petitioner, Idaho Power, construct the additions and improvements for itself or for its use only?

A. That is right.

Q. It doesn't construct the additions and improvements for sale to the public, does it?

A. No.

Q. Nor does it advertise or hold itself out as such?

A. No, we do not.

Q. Would it be fair to conclude that by reason of a substantial construction program involving its own employees which you have testified to this morning, that petitioner is required to purchase more transportation equipment than would have been needed simply for utility purposes or for maintenance purposes?

A. As I mentioned, back in '44 we got into construc-
[26] tion. There weren't contractors available and we did have to purchase additional equipment to do this construction, more than you would as an operating company.

Q. I notice in the taxable years 1962 and '63, that the amounts constructed by others under contract diminished quite a bit.

A. This is right.

Q. In view of that, would you say that you have to think in terms of buying more transportation equipment for construction purposes than for only utility purposes or maintenance work?

A. A lot of this equipment that was used and is still being used was available even as of now. However, in later years, as we got into tension equipment and pulling equipment as they are now using in construction, this equipment had to be purchased.

Q. And it was being purchased for the purpose of construction, was it not?

A. Not at all. In other words, you have to maintain the property after it is built and if you have a contractor, an outside contractor come in and build these facilities, he leaves when the job is finished and you have to have some way of connecting this tower, some way of restringing the conductor that is torn out by this, because your contractor isn't there. In our area, we are not as fortunate as they are in other locations where contractors are available.

[27] Q. I don't know that you are getting my question. You are buying this transportation equipment for use in construction, for use in constructing your own projects?

A. This is right.

Q. Now, could the petitioner have done with less transportation equipment if its construction projects had been performed entirely by outsiders?

A. I would say that would be true.

Q. Would you say that by reason of the nature of some of the construction, that some of the transportation equipment purchased was primarily for construction purposes?

A. That and maintenance of the constructed facilities.

Q. Take the large equipment, the very large equipment like the shovels and like that, wouldn't that have been purchased for the purposes of construction only?

A. I presume you could refer to that as a large crane, for instance. Is this what you are referring to?

Q. Yes.

A. We would have to have that for maintenance and we are using that every day in maintenance work and in our transportation and distribution substations.

Q. So I imagine—

A. (Interrupting) It is used both.

Q. It is used for both.

And you don't know of any equipment that was purchas- [28] ed that, because of its nature, is suitable primarily for construction purposes only?

A. I believe we use our equipment both in construction and maintenance.

Q. I understand that, from Mr. Kern, that you have read the stipulation of facts in this case.

A. I have, yes.

Q. Now, the parties have stipulated in paragraph 14, the extent of the stipulation, that the extended use in constructional costs of operating and maintaining transportation equipment, except for pension contributions, Social Security taxes, motor vehicle taxes and depreciation were capitalized by the petitioner for tax purposes.

A. I am afraid I can't answer that.

Q. There is no answer. I am just saying we have stipulated that. Would you please describe some of the costs involved in operating and maintaining transportation equipment used in the construction?

A. Well, there is fuel, tires, repairs. This covers the largest items.

Q. How about the wages and salaries of employees?

A. That is not a part of the equipment charged in our jobs. What I mean, that it goes in as man-hour cost.

Q. Wages of employees who operate the equipment?

A. That is man-hour costs. It isn't charged with the [29] equipment.

Q. But do you know whether it is charged to the construction? It is, is it not?

A. It is charged to the job, but not as a contractor would on a piece of operating equipment.

Q. So, then how about costs of transporting the employees and materials and supplies and tools to and from the points of construction?

A. We do that.

Q. That is charged to the job, isn't it, construction?

A. Right.

Q. One other question. How about overhead expenses, like general superintendent?

A. That is, on a project job, it is charged directly to the job. On a smaller job or a nonproject job, it is cleared through the clearing accountant.

MR. PICCO: That is all.

THE COURT: Do you have anything further, Mr. Kern?

MR. KERN: No, I have not, Your Honor.

THE COURT: Thank you, Mr. Servis. You are excused.

(Witness excused.)

THE COURT: Do you have any other evidence to present?

MR. KERN: No, I do not, Your Honor. The stipulation and the witness is all we had.

THE COURT: Then you rest?

[30] MR. KERN: Yes, Your Honor.

THE COURT: Do you have anything?

MR. PICCO: We rest, too, Your Honor.

* * * *

TAX COURT OF THE UNITED STATES
WASHINGTON

[SEAL]

Docket No. 4012-67

IDAHO POWER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion, filed April 13, 1970, it is

ORDERED AND DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1962 and 1963 in the amounts of $73,023.47 and $50,342.21, respectively.

Entered Apr. 23, 1970.

/s/ Irene F. Scott
Judge.

SUPREME COURT OF THE UNITED STATES

No. 73-263

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IDAHO POWER COMPANY

ORDER ALLOWING CERTIORARI. Filed November 5, 1973

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1973 527222 131

In the Supreme Court of the United States

OCTOBER TERM, 1973

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IDAHO POWER COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Appendix A, *infra*, pp. 10–19) are not officially reported. The opinion of the court of appeals (Appendix B, *infra*, pp. 20–37) is reported at 477 F.2d 688.

JURISDICTION

The judgment of the court of appeals (Appendix C, *infra*, p. 38) was entered on April 10, 1973. By order dated July 5, 1973, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including August 8, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

517-504—73——1

QUESTION PRESENTED

Whether the depreciation on equipment owned and used by the taxpayer in the construction or improvement of its capital facilities must be capitalized as part of the cost of those facilities.

STATUTES INVOLVED

Sections 161, 167, and 263 of the Internal Revenue Code of 1954, 26 U.S.C. 161, 167, and 263, provide in pertinent part as follows:

> Section 161. In computing taxable income * * *, there shall be allowed as deductions the items specified in this part [Sections 161 through 188], subject to the exceptions provided in Part IX (sec. 261 and following, relating to items not deductible).
>
> Section 167(a). There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business * * *.
>
> Section 263(a). No deduction shall be allowed for—
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

STATEMENT

Respondent is a public utility company engaged in the production, transmission, distribution and sale of electric energy.[1] In connection with its principal business, respondent also constructs additions and improvements to its capital facilities. Some of this con-

[1] The facts recited herein are taken from the Tax Court's memorandum findings of fact (Appendix A, *infra*, pp. 10–13).

struction is done by independent contractors, but much of it is done directly by respondent, using its own employees and equipment. The major construction work consists of additions to or improvements in transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities.

In performing its own construction work, respondent uses a wide variety of automotive transportation equipment, including passenger cars, trucks of all description, power operated equipment and trailers, and so forth. For its general accounting purposes, including reporting to regulatory agencies responsible for rate-making and other related determinations, respondent treated the depreciation on this equipment, to the extent it was used in construction, as part of the cost of the capital facilities so constructed. Thus for accounting purposes the depreciation was capitalized and then amortized over the life of the capital facilities.[2] For tax purposes, however, respondent treated the depreciation not as a capital expenditure but as a currently deductible item of expense.

The Commissioner determined that the construction-related depreciation on respondent's equipment was a nondeductible capital expenditure under Sec-

[2] Respondent also capitalized substantially all the costs of operating and maintaining the construction equipment, including the wages paid to operators, the cost of fuel, and so forth, as well as the cost of tools and other materials wholly consumed in the course of construction. Respondent does not contest the propriety of treating these items as nondeductible capital expenditures for tax purposes.

tion 263 of the Internal Revenue Code of 1954, 26 U.S.C. 263. He therefore adjusted respondent's federal income tax returns for the taxable years in question, 1962 and 1963, by disallowing the construction-related depreciation on equipment, adding the amount of the disallowed depreciation to respondent's adjusted basis in its capital facilities, and accordingly increasing the depreciation allowed with respect to those facilities. The net effect of these adjustments was to increase respondent's tax liability for 1962 by $140,429.75 and for 1963 by $96,811.95.

The Tax Court sustained the Commissioner's determination (Appendix A, *infra*). The court of appeals reversed (Appendix B, *infra*), apparently reasoning alternatively that construction-related depreciation is not a capital expenditure under Section 263 of the Code and that Section 263 does not in any event bar the deduction of capital expenditures which would otherwise be deductible as depreciation under Section 167.

REASONS FOR GRANTING THE WRIT

1. The court of appeals has decided a question of major significance to the administration of the Internal Revenue Code in a manner which conflicts with the result in the only other reported case expressly addressing that issue, *Southern Natural Gas Co. v. United States*, 412 F. 2d 1222, 1264–1269 (Ct. Cl.). Unless reversed, the decision below will have a substantial adverse effect on the revenues. The Internal Revenue Service estimates that acceptance of the decision below could result, in the first year, in a revenue loss from the electric utility industry alone of approxi-

mately forty million dollars.[3] Railroads, other utilities, and major industrial corporations are also affected. Heretofore, such taxpayers, in filing their returns, have generally followed a method of depreciation accounting similar to that urged by the Commissioner in this case. If the issue now raised is not quickly resolved by this Court, further litigation involving, in the aggregate, hundreds of millions of dollars in refund claims may be anticipated.

2. Good accounting practice requires the capitalization of all costs incurred in the acquisition of capital assets. When a taxpayer acquires a capital asset by constructing it, this principle requires capitalization of the construction costs themselves. The application of this principle is of course clear with respect to expenditures such as wage payments to construction workers and purchase costs of construction materials. But it also applies to the cost of operating construction equipment, including the wear and tear, or depreciation, of the equipment itself. See, *e.g.*, Paton, *Asset Accounting: An Intermediate Course,* pp. 192–193 (1st ed.); Finney & Miller, *Principles of Accounting—Introductory,* pp. 246–247 (6th ed.).[4]

---

[3] Revenue losses in subsequent years could be expected to decline. The issue presented here, as in, for example, *Schlude* v. *Commissioner*, 372 U.S. 128, and *American Automobile Assn.* v. *United States*, 367 U.S. 687, involves the deferral of taxes. But in a growing economy, the annual revenue losses resulting from such a deferral would continue indefinitely.

[4] The court of appeals inferred from the 1954 liberalization of tax depreciation rules under Section 167 a congressional purpose of favoring immediate deductions over capitalization. But those liberalized rules, the application of which is not at issue here, were intended to "give the economy added stimulus and resilience *without departing from realistic standards of depreciation accounting.*" H. Rep. No. 1337, 83d Cong., 2d Sess., p. 24 (1954). (Emphasis added.)

Construction-related depreciation is simply one more item of cost incurred in acquiring a capital asset. As such, good accounting practice requires that it be capitalized and amortized over the useful life of that capital asset, *i.e.* over the period that asset is used in the production of income.[5] This treatment of construction-related depreciation follows from the fundamental accounting principle that expenditures are to be deducted as expenses only in the period or periods during which they are associated with the production of income: construction-related depreciation is associated with the production of income not when it is originally incurred, but over the life of the asset constructed.

Elementary principles of income taxation are in agreement with good accounting practice on this issue. The general principle that a taxpayer's construction costs must be capitalized and amortized over the life of its newly constructed facility has long been established. See, *e.g., Great Northern Railway Co.* v. *Commissioner,* 8 B.T.A. 225, 260–263, affirmed, 40 F. 2d 372 (C.A. 8), certiorari denied, 282 U.S. 855. Respondent concedes this point with respect to the normal expenses of operating and maintaining its construction equipment. See note 2, *supra.* Respondent balks only at the capitalization of depreciation.

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[5] In recognition of the dictates of good accounting practice, both the Federal Power Commission and the Idaho Public Utilities Commission have required respondent to capitalize construction-related depreciation in its reports to them. See Appendix A, *infra,* p. 12; Appendix B, *infra,* p. 22.

But in adjudicating tax cases this Court has frequently pointed out that "the purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset." *Hertz Corp.* v. *United States*, 364 U.S. 122, 126. The periods benefited by a taxpayer's use of equipment to construct its own capital facilities are those during which the facilities so constructed are themselves used for the production of income. Thus immediate deduction of construction-related depreciation would be inappropriate. The proper matching of items of income and expense can be achieved only by treating construction-related depreciation in the same manner as other construction expenditures, *i.e.*, as nondeductible capital expenditures that must be added to the adjusted basis of the new facility.[6]

3. This result is also required by the clear language of the Internal Revenue Code. The deduction for depreciation is provided by Section 167. Respondent claims that its construction equipment was used in its trade or business and therefore is subject to the provisions of that Section. We concede that Section 167, read alone, literally applies to respondent's construction equipment. But Section 167 cannot be read alone: Section 161 makes all business-related deductions, including the deduction for depreciation under Section

[6] This treatment maintains a tax parity between the taxpayer that constructs its own facilities and one that hires an independent contractor. The latter taxpayer must of course capitalize the entire amount of the construction costs charged by the contractor, and in any normal arm's-length agreement this amount will cover the depreciation incurred by the contractor in using his equipment.

167, "subject to the exceptions provided in [Sections 261 through 279]." And Section 263 broadly disallows any deduction for "[a]ny amount paid out for new buildings or for permanent improvements or betterments * * *."[7] The Treasury Regulations, 26 C.F.R. 1.263(a)-2(a), confirm that the disallowance under Section 263 extends to the "*cost of* acquisition, *construction, or erection* of buildings * * * and similar property * * *." (Emphasis added.)

Apparently the principal ground of decision below was that, although Section 263 may require the capitalization of other costs of construction, it does not extend to construction-related depreciation because such depreciation is not an "amount paid." But that statutory expression does not refer only to actual payments. For example, respondent properly has never claimed that it could deduct, rather than capitalize, the construction workers' wages or construction materials' purchase costs accrued but not actually paid during a taxable year, even though such accruals are not "amount[s] paid" under the reading of the court below. This illustrates that the statutory phrase "amount paid out" was not intended to invoke

[7] The court of appeals expressed the view that Section 263 disallows only those expenses which would otherwise be deductible only as ordinary and necessary business expenses under Section 162. But the broad language of Section 263 ("No deduction shall be allowed * * *") and of Section 161 ("* * * the items specified in this part [are] subject to the exceptions provided in part IX * * *") does not admit of such a narrow construction. Cf. *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (involving capitalization of expenditures which the taxpayer sought to deduct as interest payments under Section 163).

the principles of cash-basis accounting, as the court of appeals mistakenly concluded, but instead was used synonymously with "cost incurred."[8] Respondent's construction-related depreciation is a cost incurred in the acquisition of new capital facilities, and as such it is a nondeductible capital item under the statute.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

ROBERT H. BORK,
Solicitor General.
SCOTT P. CRAMPTON,
Assistant Attorney General.
KEITH A. JONES,
Assistant to the Solicitor General.
ELMER J. KELSEY,
GORDON S. GILMAN,
Attorneys.

AUGUST 1973.

[8] Moreover, the narrow, technical reading of the statute by the court of appeals exhibits a basic misunderstanding of the purpose of Section 263. That purpose is to state the broad principle that capital expenditures are nondeductible; it was not intended as "a complete list of nondeductible expenditures." *Commissioner* v. *Lincoln Savings and Loan Ass'n*, 403 U.S. 345, 358. Thus Section 263 is to be read expansively, in the same manner as Section 61. Cf. *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426.

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APPENDIX A

[1] [Filed, April 13, 1970]

United States Tax Court

T.C. Memo 1970-83

Docket No. 4012-67

IDAHO POWER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Memorandum Findings of Fact and Opinion

SCOTT, *Judge*: Respondent determined deficiencies in petitioner's Federal income taxes for the calendar years 1962 and 1963 in the amounts of $73,023.47 and $50,342.21, respectively.

The only issue in this case is whether petitioner is entitled to deduct the portion of the depreciation on transportation equipment used [2] both for maintaining existing and building new facilities attributable to construction of the capital improvements.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioner, a public utility engaged in the production, transmission, distribution and sale of electric energy, was incorporated under the laws of Maine on May 6, 1915. Its principal place of business at the time of filing its petition in this case was in Boise,

Idaho. It filed its Federal income tax returns for the calendar years 1962 and 1963 with the district director of internal revenue at Boise, Idaho.

Petitioner kept its books and filed its Federal income tax returns on an accrual method of accounting.

Ever since it was organized, petitioner has engaged in some construction of additions to its property. During the latter part of World War II because of the unavailability of outside contractors, petitioner constructed all the new additions to its transmission and distribution facilities. At all other times some of its capital improvements have been constructed by contractors and some by petitioner with its own employees. At the time of the trial of this case petitioner had 140 employees engaged in new construction work. In prior years petitioner had as many as 300 employees engaged in constructing capital improvements.

[3] The approximate gross amounts of property constructed by petitioner and by others as added each year to petitioner's property-account for the years 1961 through 1963 are as follows:

Year	Gross Additions	Amount Constructed by Petitioner	Amount Constructed by Others Under Contract	Purchased Equipment
1961	$65,407,029.28	$14,609,896.38	$41,262,380.48	$9,534,752.42
1962	[1] 8,235,440.22	7,139,940.72	314,790.45	780,709.05
1973	5,988,139.56	5,642,342.79	115,792.63	230,004.14

[1] The stipulation shows this figure as $8,235,640.22. The record does not show whether the error is in the total or one of the other figures. For simplicity we have corrected the total from $8,235,640.22 to $8,235,440.22.

These additions were primarily transmission lines, transmission switching stations, distribution lines, distribution stations and connecting facilities such as roads and timber turnings.

During each of the years 1962 and 1963 petitioner owned automotive transportation equipment used in its business. Communication equipment, such as radios, was affixed to the transportation equipment and used in the operation of such transportation equipment. Petitioner used such transportation equipment in part for operation and maintenance and in part for the construction of additional facilities having a useful life of more than one year.

The types of automotive transportation equipment owned by petitioner during the years 1962 and 1963 included passenger cars, pickup trucks, light trucks, medium trucks, heavy trucks, power operated equipment and [4] trailers. All of this equipment is used for operation, maintenance and construction. Petitioner on its books uses various methods of charging the operating expenses of this equipment to operation and maintenance and construction, none of which is questioned by respondent. To the extent used in construction, petitioner on its books charged depreciation on its transportation equipment as well as all costs of operating and maintaining such transportation equipment, except pension contributions, social security taxes and motor vehicle taxes to the capital assets so constructed. Depreciation was charged either directly or through clearing accounts in accordance with accounting procedures prescribed by the Federal Power Commission which have been adopted by the Idaho Public Utilities Commission. The depreciation so capitalized on petitioner's books of account for the years 1962 and 1963 amounted to $150,047.42 and $130,523.99, respectively.

In computing its taxable income as reported on its Federal income tax returns for 1962 and 1963, petitioner capitalized as a part of the cost of construction of its capital improvements all costs of operating and

maintaining its transportation equipment which it had charged on its books to construction.

On its Federal income tax returns for the years here in issue petitioner deducted all depreciation on all its transportation equipment including depreciation allocated on its books to use of the equipment in construction. Such equipment was depreciated over a composite life of 10 years. Petitioner depreciated all of its automotive transportation [5] equipment whether or not used in construction under the straight line and declining balance methods of depreciation.

Respondent in his notice of deficiency disallowed and capitalized the deduction for depreciation on taxpayer's transportation equipment to the extent that such equipment was used in the construction of capital assets and allowed a deduction for depreciation on the amounts so capitalized over the useful life of the property constructed. The result of this adjustment was the disallowance by respondent of depreciation claimed by petitioner in the years 1962 and 1963 in the respective amounts of $140,429.75 and $96,811.95.

OPINION

Petitioner takes the position that its transportation equipment is used in its trade or business and therefore depreciation on this equipment is deductible under section 167(a)(1), I.R.C. 1954.[2] Respondent

[2] All references are to the Internal Revenue Code of 1954.

SEC. 167, I.R.C. 1954. DEPRECIATION.

"(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income."

contends that the amount of such depreciation allocable [6] to use of petitioner's equipment in the construction of capital improvements should be capitalized in accordance with the provisions of section 263(a)(1).[3]

Petitioner states that its construction of its own facilities is an appropriate activity in connection with its production and sale of electric energy and cites numerous cases for the proposition that the phrase "property used in the trade or business" means devoted to such trade or business, regardless of whether or not such property was used in activities directly productive of income. All of the cases which petitioner cites in support of this contention deal with temporarily idle assets. Typical of the holdings of the cases cited by petitioner is our statement in *Carter-Colton Cigar Co.* 9 T. C. 219, 221 (1947) that:

> Where the statute allows deductions for depreciation of property "used in the trade or business," it has been held that "used in the trade or business" means "devoted to the trade or business," and includes all such property, whether actually in use during the taxable year or not. * * *

These cases are not helpful in resolving the issue in the instant case. All the transportation equipment for which petitioner claimed depreciation was used part of the time in its trade or business of production and sale of electric energy and the portion of the [7] depreciation allocated to this "business" on petition-

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[3] SEC. 263(a) CAPITAL EXPENDITURES.

"(a) General Rule.—No deduction shall be allowed for—

"(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *"

er's books has not been disallowed by respondent. This same equipment was used part of the time to construct capital improvements and respondent contends that the amount of depreciation allocable to such use should be capitalized and in effect considered as a part of the cost of the facility constructed. Respondent contends that petitioner was not "in the trade or business" of constructing facilities and that even if this activity is considered a part of petitioner's trade or business the deduction of any capital expenditure in connection therewith is prohibited by the provisions of section 263.

Petitioner argues that there is ample authority in support of the proposition that a taxpayer's trade or business includes all activities which are appropriate to its principal business, citing cases in which various activities such as purchase of corn futures, sale of baseball player contracts, and trading in currency[4] were determined to be appropriate to the taxpayer's principal business and therefore give rise to ordinary income. These cases are likewise not helpful in resolving the issue in the instant case. Obviously the acquiring of capital improvements whether by purchase or construction is appropriate [8] if not vital to petitioner's continued operation of its business of producing and selling electric energy but this fact does not cause the cost of these capital improvements to be deductible in the year acquired. The real issue here is whether the portion of the depreciation deduction for transportation equipment allocable to the construction of capital improvements should be viewed

[4] *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955); *Hollywood Baseball Association*, 49 T.C. 338 (1968), aff'd. 352 F. 2d 350 (C.A. 9, 1969); and *American Southeast Asia Company, Inc.* 26 T.C. 198 (1956).

as a part of the "cost" of such capital improvements.

Petitioner further argues that disallowing the portion of the claimed depreciation deduction allocable to transportation equipment used in constructing capital improvements ignores the basic reason for allowing depreciation, that is, to permit a taxpayer to recoup the cost of equipment free of tax over its useful life so that it will have funds to replace such equipment.

This argument begs the question. The reason for allowing a depreciation deduction is because the statute allows this method of recovering the cost of a piece of equipment with a useful life of over one year instead of allowing the total cost of such equipment used in a trade or business to be deducted in the year of purchase as a business expense. A deduction as a business expense is allowed for the type of tools, parts and equipment used in a trade or business which do not have a useful life of over one year such as the repair parts for petitioner's transportation equipment. However, petitioner has capitalized such items allocable to the construction of capital improvements.

[9] Finally, petitioner argues that section 263(a) could not apply to depreciation since depreciation is not "any amount paid out," relying on *Maurice S. Gordon* v. *Commissioner*, 37 T.C. 986, 987 (1962) and quoting our statement therein that "The statute [Sec. 213 allowing deduction for medical expenses] permits the deduction for 'expenses paid' and 'amounts paid' and respondent correctly interprets the statute as permitting deduction for 'medical expenses actually paid.' Sec. 1.213–1(a), Income Tax Regs. Depreciation is a 'decrease in value.' *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96. Any allowance for depreciation is not an 'expense paid' or 'amount paid.'" As is

shown by the sentence preceding those quoted by petitioner and as we held in *Producers Chemical Co.*, 50 T.C. 940, 959 (1968) the case of *Maurice S. Gordon v. Commissioner, supra*, held that depreciation was not an expense paid "in the year for which the deduction was claimed" and that case has no relevance to the issue of whether depreciation is to be deducted or capitalized.

Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Petitioner does not question that the cost of tools with a life of less than one year used to construct capital assets or permanent improvements should be capitalized. Depreciation of equipment used for the construction of a capital asset is of the same nature as the cost of tools [10] "paid out" for a capital improvement. As we stated in *L. W. Brooks, Jr.*, 50 T.C. 927, 935 (1968) on appeal (C.A. 5, Feb. 10, 1969) "* * * depreciation—inasmuch as it represents a using up of capital—is as much an 'expenditure' as the using up of labor or other items of direct cost."

In *Ben Perlmutter*, 44 T.C. 382, 404 (1965) aff'd on another issue 373 F. 2d 45 (C.A. 10, 1965), we held that an allocable portion of the depreciation on vehicles used in construction of a shopping center should be capitalized, pointing out that "petitioner has the burden of establishing that the disputed expenditures were actually incurred *in carrying on* the business of the corporation, * * * and this petitioner has failed to do."

Petitioner relies heavily on *Great Northern Railway Co.*, 30 B.T.A. 691 (1934) in which we held that the taxpayer was entitled to deduct depreciation on certain equipment used in construction work.

As we pointed out in *Producers Chemical Co., supra,* at page 960, in our view "all that was held in the second *Great Northern Railway Co.* case [30 B.T.A. 691] was that the depreciation which the taxpayer there sought to deduct was incurred in carrying on the trade or business of the taxpayer." We also pointed out the distinction between *Great Northern Railway Co.,* 8 B.T.A. 225, 263 (1927) which held it proper to capitalize depreciation on equipment used to transport men for construction work, and the second *Great Northern Railway Co.* [30 B.T.A. 691 (1934)] case in some detail.

[11] In our view the issue in the instant case is indistinguishable in substance from the issue involved in *L. W. Brooks, Jr., supra, Producers Chemical Co., supra,* and *Ben Perlmutter, supra,* in each of which we held that the portion of depreciation on equipment allocable to acquisition of a capital asset is not properly deductible in the year the equipment is used to produce such asset but must be capitalized and recovered as a part of the basis of the capital asset acquired over the useful life of such asset.

Southern Natural Gas Co. v. *United States,* 412 F. 2d 1222 (Ct. of Cl. 1969), a recent case decided by Court of Claims, involved the precise issue as that involved in the instant case. The taxpayer in that case was an interstate natural gas carrier which constructed additional facilities to expand its pipeline system. Certain equipment which it owned was used primarily for the operation and maintenance of the system but from time to time was used to construct additional facilities. The Court of Claims held that the depreciation allocable to the use of the equipment in the construction of capital improvements was not deductible in the year the equipment was so used but should be capitalized and recovered over the useful

life of the assets constructed. Petitioner recognizes that the *Southern Natural Gas Co.* case is not distinguishable from the instant case but contends that the Court of Claims in accepting the report of its Commissioner as its decision on this issue wrongly decided the issue. In our view the decision of the Court of Claims in the *Southern Natural Gas Co.* case with respect to the capitalization of [12] depreciation of equipment used in the construction of capital improvements is correct. It is in accordance with our holdings in *L. W. Brooks, Jr., supra, Producers Chemical Co., supra,* and *Ben Perlmutter, supra.* That decision is also supported by a number of cases decided by this Court such as *Great Northern Railway Co.,* 8 B.T.A. 225 and *New Quincy Mining Co.* 36 B.T.A. 376, 382 (1937).

There is no dispute between the parties as to the amount of depreciation allocable to construction of capital improvements. We hold that respondent properly disallowed as a deduction in the years here in issue this allocable portion of depreciation and that such amount should be capitalized as part of petitioner's basis in the permanent improvements in the construction of which the equipment was used.

Decision will be entered for respondent.

APPENDIX B

[1] United States Court of Appeals
for the Ninth Circuit

No. 26,368

[April 10, 1973]

IDAHO POWER COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

Petition to Review a Decision of the Tax Court of the United States

Before: TRASK and CHOY, Circuit Judges, and McGOVERN,* District Judge

TRASK, *Circuit Judge:*

The taxpayer, Idaho Power Company, appeals from a Tax Court decision denying taxpayer's depreciation deduction on equipment used in the construction of capital improvements. Under the Tax Court decision the taxpayer was ordered to pay deficiencies in income taxes for the taxable years 1962 and 1963 in the amounts of $73,023.47 and $50,342.21, respectively.

The Tax Court ruled against the taxpayer on the single issue—whether the taxpayer is entitled to deduct depreciation on depreciable equipment to the extent such equipment is used in the construction of its

*Honorable Walter T. McGovern, United States District Judge, for the Western District of Washington, sitting by designation.

own capital assets. The Tax Court treated the depreciation as a cost of the construction of the new facilities and ruled such costs must be capitalized as part of the basis of the property constructed under section 263 of the Internal [2] Revenue Code of 1954.[1] We agree with the taxpayer's position that the current depreciation should be treated as a current deduction under section 167 of the Code.[2] The decision of the Tax Court is therefore reversed.

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[1] "§ 263. CAPITAL EXPENDITURES

"(a) General Rule.—No deductions shall be allowed for—

"(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

"(A) expenditures for the development of mines or deposits deductible under section 616,

"(B) research and experimental expenditures deductible under section 174,

"(C) soil and water conservation expenditures deductible under section 175, or

"(D) expenditures by farmers for fertilizer, etc., deductible under section 180."

[2] "§ 167. DEPRECIATION

"(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income.

"(b) Use of certain methods and rates.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

"(1) the straight line method,

"(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1).

The taxpayer is a public utility engaged in the production, transmission and sale of electricity. Since at least 1929, the taxpayer has regularly constructed additional transmission and distribution [3] facilities using its own employees and equipment for a major part of the work. In 1962 it constructed $7,139,940.72 worth of facilities and in 1963, $5,642,342.79 worth. In some years it has used as many as 300 employees in construction and at the time of trial 140 were engaged in such work in question. During the years, the taxpayer has owned cars, trucks, trailers and radio equipment which have been used in part to operate and maintain existing facilities and in part to construct new capital assets.

On its books the taxpayer capitalized the depreciation to the extent the equipment was used in the construction of capital assets in accordance with accounting procedures prescribed by the Federal Power Commission and adopted by the Idaho Public Utilities Commission.[3] On its income tax returns for 1962 and

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"(3) the sum of the years-digits method, and

"(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2)."

[3] It should be noted that the taxpayer in *Spring Valley Water Co.*, 5 B.T.A. 660 (1926), charged interest payments on funds borrowed for construction of a dam to its capital account as required by law for public utilities. The taxpayer was allowed a current deduction for such payments, notwithstanding the method of accounting used for its books. The fact that the taxpayer in the case at bar was required to capitalize the depreciation on its books for purposes of the Federal Power Com-

1963, however, the taxpayer deducted all depreciation on its transportation equipment, including depreciation on the equipment to the extent it was used in construction. Such equipment was depreciated over a composite life of ten years. All other costs allocable to the constructed facilities, except pension contributions, social security taxes and motor vehicle taxes, which were also deducted currently, were capitalized by the taxpayer. This included costs of operating and maintaining such equipment. The Commissioner of Internal Revenue disallowed and capitalized the deduction for depreciation on taxpayer's equipment to the extent that such equipment was used in the construction of capital assets and allowed instead a deduction for depreciation of the amounts so capitalized over the useful life of the property so constructed. The construction, consisting principally of transmission and distribution facilities, had useful lives of 30 years or longer. The result of this adjustment was the net disallowance by the Commissioner [4] of depreciation claimed by the taxpayer during the years 1962 and 1963 in the respective amounts of $140,429.75 and $96,811.95.

I. THE DEPRECIATION DEDUCTION

A re-examination of the purpose of the depreciation deduction, its place in the statutory scheme and its history will assist us in solving the problem. It is the basic theory of depreciation that capital assets

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mission and the Idaho Public Utilities Commission is likewise irrelevant as to the proper tax treatment of depreciation deductions. *See Old Colony Ry. Co.* v. *Commissioner*, 284 U.S. 552, 562 (1931); *Mine Hill & Schuylkill Haven R.R. Co.* v. *Smith*, 184 F. 2d 422 (3rd Cir. 1950), *cert. denied*, 340 U.S. 932 (1951).

which are used in the business should not be exhausted without a provision for their replacement. To that end depreciation over the life of the asset provides the means by which the taxpayer can recover its cost. One way of expressing this very practical approach was that of the Supreme Court in *Knoxville* v. *Knoxville Water Co.*, 212 U.S. 1, 13–14 (1909):

> A water plant, with all its additions, begins to depreciate in value from the moment of its use. Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provision out of earnings for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public. If a different course were pursued the only method of providing for replacement of property which has ceased to be useful would be the investment of new capital and the issue of new bonds or stocks. This course would lead to a constantly increasing variance between present value and bond and stock capitalization—a tendency which would inevitably lead to disaster either to the stockholders or to the public, or both.

Although that case did not involve an income tax problem, it states the underlying theory of the deduction.

[5] The purpose of the depreciation allowance under the Code is "to permit the taxpayer to recover his capital investment in wasting assets free of income tax." 4 *Mertens, Law of Income Taxation* § 23.04. The Supreme Court has said that the purpose of the depreciation deduction is to create a fund to restore the property, to the extent of the investment of the taxpayer, at the end of its useful life:

> The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time it is retired will with it salvage value replace the original investment therein. [*Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943).]

In *Massey Motors, Inc. v United States*, 364 U.S. 92, 96 (1960), the Supreme Court allowed a depreciation deduction on automobiles used by dealers or their employees, explaining:

> Such assets, employed from day to day in business, generally decrease in utility and value as they are used. It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets; hence it recognized that this decrease in value—depreciation—was a legitimate tax deduction as business expense. It was the purpose of § 23(l) and the regulations to make a meaningful allocation of this cost to the tax periods benefited by the use of the asset.[4]

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[4] The Treasury Regulations under the 1954 Internal Revenue Code are to the same effect:

"§ 1.167(a)-1. Depreciation in General.

"(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and

[6] The issue here does not affect the amount of the depreciation to which the taxpayer is entitled. Whether it is spread over a ten-year life or a thirty-year life, the amount remains the same. It does affect the timing of the recovery of the depreciation and thus might have a vital effect on the ability of a taxpayer to maintain and replenish its equipment inventory without depleting its working capital or burdening its borrowing capacity.

The legislative history of the depreciation deduction clearly supports our decision in favor of the taxpayer. "Prior to the enactment of the Internal Revenue Code of 1954, the statutory provisions for depreciation were singularly brief." 4 *Mertens, supra* at § 23.01. Section 23 (l) of the 1939 Act, contained only a bare statement similar to the general rule in section 167(a) of the 1954 Act,[5] and a two sentence paragraph stating the method of computation as between a life tenant and a remainderman. When Congress adopted the Internal Revenue Code of 1954, however, it gave particular attention to liberalized depreciation allowances. It provided for the use of new methods and rates, in addition to the standard straight line method. These included a declining balance method, a sum of the years-digits method and a fourth

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obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and section 1.167(g)–1."

[5] *Supra* note 2.

method which was any one consistently applied so long as the total at the end of each year did not exceed the allowances which would have resulted from the use of the declining balance method.*

Further, the report of the Ways and Means Committee on H.R. 8300, which became the Internal Revenue Code of 1954, stated at the beginning of its discussion of this subject:

> "Your committee's bill provides for a liberalization of depreciation with respect to both the estimate of useful life of property and the method of allocating the depreciable cost [7] over the years of service." H.R. No. 1337, 83rd, Cong., 2nd Sess., 1954 U.S. Code Cong. & Adm. News at 4047.

The report emphasized the importance of the liberalized policies of the bill. It pointed out its reliance upon the use of an improved declining balance method of computing depreciation which "concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness." *Id.* at 4048. The report continued:

> More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high

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* The Ways and Means Committee noted:

"The depreciation allowances under this method, therefore, [declining-balance] are considerably larger in the early years of the life of a property than those resulting from the straight-line method. The declining-balance method at twice the appropriate straight-line rate will write off approximately 40 percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life." H.R. No. 1337, 83rd Cong., 2nd Sess., 1954 U.S. Code Cong. & Adm. News at 4047.

level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax write-off would increase available working capital and materially aid growing business in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living. [*Id.*]

II. TAXPAYER'S ARGUMENT

The taxpayer argues that deductions specifically allowed and set out under the Internal Revenue Code of 1954 should not be capitalized even though incurred by the taxpayer in constructing facilities for its own use. Such deductions include interest (section 163), taxes (section 164) and depreciation (section 167). These particular deductions, expressly enumerated in the Code, differ from the general deduction for ordinary and necessary business expenses, which is not available whenever the amount expended is determined to be a capital expenditure rather than a current business expense. This interpretation of the Code's overall scheme is in harmony with the Tax Court's decision in *All-Steel Equipment Inc.*, 54 T.C. 1749 (1970), *rev'd on other grounds,* 467 F. 2d 1184 (7th Cir. 1972).

[8] The issue there was whether certain expenditures for taxes, losses and research and experiment were to be included in the cost of inventory (comparable to the capitalization of expenditures for capital assets). Because these three items are expressly listed

in the Code as proper deductions under sections 164, 165 and 174, they are not to be deferred even though they relate to inventory or capital items. The Tax Court explained:

> Secondly, the petitioner contends that the respondent also erred in his determination by requiring the inclusion of certain costs in inventory even though the current deductibility of such costs is expressly authorized by the Code and regulations. The expenditures referred to by the petitioner involve costs incurred for repairs, taxes, losses, and research and experiment. We agree with the petitioner that such expenditures are currently deductible and are excludable from inventory costs.
>
> Deductions for taxes, losses, and research and experiment are expressly authorized in the year the taxes are paid or accrued, the losses are sustained, or the research and experimental expenditures are paid or incurred. Secs. 164, 165, 174. Neither the statutory provisions nor the regulations indicate in any way that such deductions are limited to current expenses as distinguished from capital expenditures for the acquisition of capital assets or inventory. To the contrary, it has been held that deductions expressly granted by statue are not to be deferred even though they relate to inventory or capital items. *Montreal Mining Co.*, 2 T.C. 688 (1943); *Spring Valley Water Co.*, 5 B.T.A. 660 (1926); *Pacific Coast Redwood Co.*, 5 B.T.A. 423 (1926). See also *Joe W. Stout*, 31 T.C. 1199 (1959), affirmed and modified on other issues sub nom. *Rogers v. Commissioner*, 281 F.2d 233 (C.A. 4, 1960). *Cf.* sec. 266; *Rev. Rul.* 141, 1953-2 C.B. 101. Moreover, section 174 expressly states that research and experimental expenditures may be treated 'as expenses which are not chargeable to capital account.' [54 T.C. at 1759.]

Depreciation, under section 167, is likewise expressly listed as a proper deduction and no exception is made should it relate to a capital item.[7]

[9] The precise issue of this case was raised in an early railroad case. *Great Northern Ry. Co.*, 30 B.T.A. 691 (1934). The railroad there, like the taxpayer here, used its equipment for the construction of additions to the taxpayer's property. The court reversed the Commissioner's determination and held that the full amount of depreciation of the equipment, including the period that it was used for construction, should be allowed. The court decided the equipment was used by its owner in a trade or business as the taxpayer maintained and that "it is a part of the regular business of a railroad to construct additional capital facilities for the transaction of its business as a common carrier." 30 B.T.A. at 708. The allowance of the depreciation deduction rather than capitalization of such costs was deemed appropriate because the statutory conditions for the deduction were satisfied.[8]

In further support of its position, taxpayer points out that section 263 providing for capital expenditures states:

> (a) . . . No deduction shall be allowed for—
> (1) Any amount *paid out* for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." [Emphasis supplied]

The use of the term "paid out," argues the taxpayer, was not without significance. There is nothing

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[7] Depreciation was apparently not before the court in *All-Steel Equipment, Inc.*

[8] The revenue laws have uniformly required that a depreciation deduction be allowed for "property used in the trade or business." 4 *Mertens, Law of Federal Income Taxation* § 23.03.

in the Internal Revenue Code which says that for purposes of section 263 depreciation is an amount "paid out" or an "expenditure." On the contrary in construing other sections, the decisions have held that depreciation is not an amount "paid out." In section 170(a)(1), for example, a deduction is allowed for "... any charitable contribution ... payment of which is made within the taxable year." It has been held that an allowance for depreciation is not a payment within the meaning of this section. Thus in *Orr* v. *United States,* 343 F. 2d 553 (5th Cir. 1965), a taxpayer used his automobile and airplane in work for the Methodist Church. The court held that a charitable deduction was not permissible to the extent of the depreciation arising from such activity because such an allowance was not a payment.

> [10] It is entirely possible, as the taxpayer suggests, that Congress and its Committees were not thinking of depreciation when they used the word "payment". The absence of any evidence as to whether Congress focused on this problem provides no basis for extending the meaning of payment to include "depreciation". A depreciation expense is an indispensable element in accounting. But it is not a "payment", not a transfer of money or property. We are bound by plain, prosaic language of the statute. [343 F. 2d at 556.]

In *Clinton H. Mitchell,* 42 T.C. 953 (1964), the Tax Court said:

> Depreciation is a "decrease in value." *Massey Motors, Inc.* v. *United States,* 364 U.S. 92. It is not a payment, or expenditure, or an out-of-pocket expense. Hence, it cannot be considered as a contribution, payment of which is made within the taxable year. 42 T.C. at 973.

As another example, we note that section 213 of the Internal Revenue Code provides for deduction of medical and dental expenses equal to:

> (1) The amount by which the amount of the expenses paid during the taxable year . . . exceeds three percent of the adjusted gross income. . . .

In *Maurice S. Gordon*, 37 T.C. 986 (1962), it was held that depreciation on an automobile used to transport a taxpayer's son to a doctor could not qualify as a medical expense upon the ground that it was not "an amount paid."

> The statute permits the deduction for "expenses paid" and "amounts paid" and respondent correctly interprets the statute as permitting deduction for "medical expenses actually paid." Sec. 1.213–1(a), Income Tax Regs. Depreciation is a "decrease in value." *Massey Motors Inc.* v. *United States*, 364 U.S. 92, 96. Any allowance for depreciation is not an "expense paid" or "amount paid." [37 T.C. at 987.]

It appears to us there is both merit and judicial support for the taxpayer's argument here.

III. THE TAX COURT DECISION

[11] The Tax Court disposed of the taxpayer's arguments by emphasizing that depreciation incurred in the acquisition of capital assets should be treated as part of the cost thereof. In Revenue Ruling 59–380, 1959–2 Cum. Bul. 87, the Internal Revenue Service specifically dealt with the issue in this case:

> Depreciation sustained on construction equipment owned by a taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to

and made a part of the cost of the capital improvements. So much thereof as is applicable to the cost of depreciable capital improvements is recoverable through deductions for depreciation over the useful life of such capital improvements.

In the instant case the capital improvements constructed constitute property to be used in the trade or business or property held for the production of income. However, the building equipment used in the construction cannot be considered as property used in the regular trade or business of the taxpayer.

In a recent case factually similar to this case, the Court of Claims followed Revenue Ruling 59–380. *Southern Natural Gas Co.* v. *United States,* 412 F. 2d 1222, 1264–69 (Ct. Cl. 1969).[9] The taxpayer contends the court's decision was erroneously based on incorrect assumptions. We agree. First, the Court of Claims could see no reason "for carving out a special exception for depreciation" on the automotive equipment of the company to the extent it was used to construct additional pipelines for its own capital improvements. Neither the Southern Natural Gas Company nor the Idaho Power Company, however, was seeking a special exception. Both based their claims on the express language of the Internal Revenue Code authorizing a depreciation deduction.

Second, the Court of Claims was concerned that a double recovery of cost would result if a depreciation deduction were cur-[12]rently allowed on the equipment—first, when the depreciation was deducted and second when the constructed asset was depreciated

[9] The Court of Claims approved the decision of the Trial Commissioner. Neither the taxpayer nor the United States took exception to the Commissioner's finding on the issue involved here.

or sold. This assumption is patently incorrect. There is no possibility of double recovery because the cost basis of the capital asset would not include the depreciation theretofore deducted.

Third, the court harbored an unfounded fear that the interpretation urged by the appellant if pushed to its logical conclusion would leave the taxpayer without a basis for self-constructed assets. A taxpayer's actual expenditures for labor and materials, however, must be capitalized as part of the basis of the capital improvements under the requirements of section 263 which provides for capitalization of amounts "paid out" for capital assets. Such expenses have to be capitalized even though they are expended for self-constructed assets. Also, as we have noted above, the costs of operating and maintaining the equipment must be capitalized. For these reasons we are not persuaded by *Southern Natural Gas* and we conclude Revenue Ruling 59-380 is an improper and incorrect interpretation of the law.[10]

Furthermore, the strong factual record in this case supports the taxpayer's contention that equipment used to construct its own capital improvements is used in the trade or business of the taxpayer as section 167 requires. The continuity and regularity of taxpayer's construction activities, the number of employees engaged in construction and the amounts ex-

[10] A revenue ruling, as distinguished from a regulation or a Treasury decision, does not have the force and effect of law. It is merely the opinion of a lawyer in an agency. A revenue ruling in conflict with revenue statutes is, therefore, without any force. *See, e.g., Bartels v. Birmingham*, 332 U.S. 126 (1947); *Stubbs, Overbeck & Assoc. Inc. v. United States*, 445 F.2d 1142. (5th Cir. 1971); *Lincoln Savings & Loan Ass'n. v. Commissioner*, 422 F.2d 90 (9th Cir. 1970), *rev'd on other grounds*, 403 U.S. 345 (1971); 1 *Mertens, supra* at § 3.20.

pended on construction all point to the conclusion that construction of facilities is a major aspect of the taxpayer's trade or business. These activities are auxiliary operations incident to the taxpayer's principal trade or business of producing, transmitting, distributing and selling electrical energy within the meaning of section 167.[11] We, there- [13] fore, are constrained to distinguish this case from *Southern Natural Gas* where the court determined the taxpayer's equipment was not used in the taxpayer's trade or business to the extent it was used to construct capital assets.[12]

Other cases cited by the Tax Court concerning oil and gas leases are factually distinguishable from the self-constructed capital asset cases. In *L. W. Brooks, Jr.*, 50 T.C. 927 (1968), and *Producers Chemical Co.*, 50 T.C. 940 (1968), the issues involved the allocation of operating costs between two taxpayers—the operator's working interest in a leasehold and his production payment toward acquisition of the leasehold. These cases are analogous to allocation of costs between a life tenant and a remainderman. They are inapposite here where there is only one taxpayer involved. Likewise, *Ben Perlmutter*, 44 T.C. 382 (1964), aff'd, 373 F. 2d 45 (10th Cir. 1967), cited by the Tax Court, was decided on a question of fact. No legal issue was raised as to the validity of a depreciation

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[11] The undisputed testimony of the Superintendent of Engineering and Construction for the company was that construction was undertaken by the company because it thus obtains a better facility at less cost and because contractors are not always available to perform the work. R.T. at 22.

[12] The Tax Court here stated, "[o]bviously the acquiring of capital improvements whether by purchase or construction is appropriate if not vital to petitioner's continued operation of its business of producing and selling electric energy . . . ." C.T. at 41-42.

deduction for vehicles used in construction. The extent of their use, if any, was questionable and the issue thus was inconsequential. We do not deem it to be in point on the issue before us.

The judgment is reversed.

United States Court of Appeals for the Ninth Circuit

No. 26,368

IDAHO POWER COMPANY, PETITIONER-APPELLANT

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

Before: TRASK and CHOY, Circuit Judges, and McGOVERN,* District Judge

Order for Amendment of Opinion

Page 7 of the slip opinion in the above case is hereby amended by adding a new paragraph at the conclusion of the discussion of point I "The Depreciation Deduction", and just before the beginning discussion of point II "The Taxpayer's Argument", to read as follows:

> Obviously the decision of the court below does not permit the purpose of either the statute, the regulations, the legislative history or the cases interpreting them from being achieved. The assets, for which a depreciation deduction is sought here, have a useful life of ten years. No dispute appears to exist as to this point. If the plain language of the statute is to be fol-

* Honorable Walter T. McGovern, United States District Judge, for the Western District of Washington, sitting by designation.

lowed, the taxpayer should by depreciation allowances recover the cost of those assets within that ten-year period. Yet such costs will not be fully recovered for 30 years if the Commissioner's determination requiring transfer of the depreciation to the new asset is applied.

APPENDIX C

[Filed and entered April 10, 1973]

United States Court of Appeals for the Ninth Circuit

No. 26,368

IDAHO POWER COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

Judgment

UPON PETITION to Review a Decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed.

A TRUE COPY
ATTEST: May 1, 1973
Dennis R. Mathews, Clerk
by M. Turley, Deputy

U.S. GOVERNMENT PRINTING OFFICE: 1973

FILE COPY

Supreme Court, U. S.
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MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

IDAHO POWER COMPANY,

Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

FRANK NORTON KERN
REID & PRIEST
40 Wall Street
New York, New York 10005
Counsel for Respondent

LAWRENCE CHASE WILSON
REID & PRIEST
40 Wall Street
New York, New York 10005
Of Counsel

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

—v.—

IDAHO POWER COMPANY,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Question Presented

When a taxpayer uses its depreciable equipment to construct other depreciable properties for use in its trade or business should depreciation on the equipment be deducted over its own useful life under section 167 of the Internal Revenue Code of 1954 or capitalized under section 263 of the Code and deducted over the useful lives of the properties constructed?

Statutes Involved

Sections 161, 167 and 263 of the Internal Revenue Code of 1954, 26 U.S.C. 161, 167 and 263, provide in pertinent part as follows:

> Section 161. In computing taxable income * * *, there shall be allowed as deductions the items specified in

this part [sections 161 through 188], subject to the exceptions provided in Part IX (sec. 261 and following, relating to items not deductible).

Section 167(a). There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business * * *.

Section 263(a). No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) expenditures by farmers for fertilizer, etc., deductible under section 180, or

(E) expenditures by farmers for clearing land deductible under section 182. * * *

Statement of the Case

This case concerns deficiencies in United States income taxes determined by the Commissioner of Internal Revenue against Idaho Power Company for the years 1962 and 1963. Idaho Power Company is a public utility engaged in the production, transmission, distribution and sale of electric energy. The taxpayer has additions to its properties constructed by others under contracts and also constructs such additions with its own employees and equipment. During

the years 1962 and 1963, taxpayer owned transportation equipment including passenger cars, various types of trucks, power-operated equipment and trailers which were used for taxpayer's operations and maintenance and for construction of taxpayer's facilities. Communications equipment, such as radios, was affixed to the transportation equipment and used in the operation of such transportation equipment.

This equipment was depreciated for tax purposes over a composite life of 10 years. The facilities which such equipment was in part used to construct had useful lives of 30 years or longer.

Depreciation on the transportation equipment to the extent used in the construction of capital assets was charged on taxpayer's books to the assets so constructed in accordance with accounting procedures prescribed by the Federal Power Commission which have been adopted by the Idaho Public Utilities Commission.

For tax purposes, to the extent the transportation equipment was used in construction of capital assets taxpayer capitalized all costs of operating and maintaining such equipment and deducted currently pension contributions, social security taxes, motor vehicle taxes and depreciation.

The Commissioner of Internal Revenue accepted this tax treatment with one exception. The Commissioner disallowed and capitalized deductions for depreciation on taxpayer's transportation equipment to the extent that such equipment was used in construction of capital assets and allowed a deduction for depreciation of the amounts so capitalized over the useful lives of the properties constructed. The action of the Commissioner of Internal Rev-

enue was upheld by the United States Tax Court; *Idaho Power Company* v. *Commissioner of Internal Revenue*, Docket No. 4012-67, T. C. Memo Decision 1970-83, April 13, 1970.

The United States Court of Appeals for the Ninth Circuit reversed the Tax Court and held that depreciation on the transportation equipment should be treated as a current deduction under section 167 of the Code; *Idaho Power Company* v. *Commissioner of Internal Revenue*, 477 F.2d 688 (9th Cir., 1973).

ARGUMENT

I.

The decision of the Court of Appeals does not warrant review by the Supreme Court because it is clearly correct.

The decision below, holding that depreciation on taxpayer's transportation equipment was a current deduction, carefully analyzed and correctly applied the provisions of the Internal Revenue Code of 1954 and is so clearly correct that it should not be reviewed by the Supreme Court. This decision initially determined that the taxpayer's equipment was depreciable under section 167 of the Internal Revenue Code of 1954. The Court then analyzed section 263 of the Code and determined that this section did not require capitalization of depreciation on taxpayer's equipment. This interpretation is clearly correct.

Section 263 requires capitalization only of an "amount paid out" or of "expenditures". Depreciation is clearly not an "amount paid out" or an "expenditure". The Courts

and the Commissioner of Internal Revenue have consistently taken the position that depreciation is not an "amount paid out" or "expenditure" in the context of the deductions for charitable contributions and medical expenses and in similar situations. *John Herbert Orr* v. *United States*, 343 F.2d 553 (5th Cir., 1965); *Clinton H. Mitchell* v. *Commissioner of Internal Revenue*, 42 T.C. 953 (1964), acq. 1965-2 C.B. 6; *Maurice S. Gordon* v. *Commissioner of Internal Revenue*, 37 T.C. 986 (1962); *Stanley G. Calafut* v. *Commissioner of Internal Revenue*, T.C. Memo. 1964-239, reported unofficially at 23 T.C.M. 1431 (1964); Revenue Procedure 70-24, 1970-2 C.B. 505 and Revenue Procedure 64-15, 1964-1 C.B. (Part 1) 676; *cf. Massey Motors, Inc.* v. *United States*, 364 U.S. 92 (1960); *United States* v. *Charles A. Ludey*, 274 U.S. 295 (1927); and *State Mutual Life Assurance Company of Worcester* v. *Commissioner of Internal Revenue*, 246 F.2d 319 (1st Cir., 1957).

The Court of Appeals did not base its decision on the principles of the cash method of accounting but instead applied the statute as enacted by Congress and held that section 263 requires capitalization only of an "amount paid out" and "expenditures" and that depreciation is neither. It is submitted that this determination is so clearly correct that it does not warrant review by this Court.

II.

The deduction for depreciation is to be allowed in accordance with the intention of Congress as manifested in the Internal Revenue Code.

It is fundamental to taxation that the allowance of deductions to a taxpayer is governed by the intention of Congress as manifested in the Internal Revenue Code and not by general principles of accounting.[1] This concept has clearly been recognized by the Commissioner of Internal Revenue in the instant case in that there has been no challenge to taxpayer's deductions for pension contributions, social security taxes and motor vehicle taxes associated with the construction of capital assets. In an accounting sense the depreciation at issue is no more or less a part of the costs of construction of capital assets. Just as in the case of these other deductions, Congress has provided for the current deduction of depreciation and has not required its capitalization in accordance with some general accounting concept. It is submitted that the allowance for depreciation in respect to taxpayer's equipment is to be governed by the intention of Congress as manifested in the statute.

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[1] While under general accounting principles it may be proper to match items of income with related expenses, this principle of matching is clearly not controlling for tax purposes. *Mark E. Schlude* v. *Commissioner of Internal Revenue*, 372 U.S. 128 (1963); *American Automobile Association* v. *United States*, 367 U.S. 687 (1961); *Hagen Advertising Displays, Inc.* v. *Commissioner of Internal Revenue*, 407 F.2d 1105 (6th Cir., 1969); *Breeze Corporations, Inc.* v. *United States*, 117 F. Supp. 404 (Ct. Cl., 1954); and *Marquardt Corporation* v. *Commissioner of Internal Revenue*, 39 T.C. 443 (1962), acq. and nonacq. on other issues 1965-2 C.B. 6, 7.

Congress has recognized that accelerated cash flow through the allowance for depreciation is essential to the modernization and growth in the productive capacity of United States industries and is necessary in order to enable United States industries to meet foreign competition. In adopting the Internal Revenue Code of 1954 Congress recognized that the depreciation policies under the 1939 Code failed to encourage the replacement of obsolete equipment and did not encourage growth in productive capacity. The extent of this problem was indicated in the report of the Committee on Ways and Means which contains the following statement:

> "There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installation of modern, up-to-date machinery. Under long-run peacetime conditions, in the absence of the inflationary pressures existing in the forced-draft economy of the postwar period, present tax depreciation methods might depress business capital expenditures below the level needed to keep the economy operating at high levels of output and employment." (House Report No. 1337, 83d Cong., 2d Sess., p. 22)

Recognizing this problem Congress in enacting the Internal Revenue Code of 1954 provided more liberal depreciation allowances in the form of accelerated depreciation. It is clear that the purpose underlying such liberalized depreciation allowances was to encourage the modernization of plant equipment and to increase the productive capacity of United States industries. The report of the Committee on Ways and Means clearly sets forth this purpose in the following statement:

"More liberal depreciation allowances are anticipated to have far reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living."[2] (House Report No. 1337, 83d Cong., 2d Sess., p. 24)

Beginning with the adoption of the 1954 Code both Congress and the Department of the Treasury, having recognized the importance of rapid cost recovery through depreciation as a means for increasing productive capacity and meeting foreign competition, have provided for methods of depreciation which emphasize the rapid recovery of the cost of an asset in order to provide a taxpayer with an adequate cash flow to purchase or construct new equipment or facilities. At section 167(b), subject to certain limitations, a taxpayer is permitted to compute depreciation not only under the straight-line method of depreciation but also the double declining-balance method and by the sum-of-the-years' digits method. These two methods result in much larger depreciation deductions in the early portion of the life of a capital asset than does the straight-line method. This fact was explained in the report of the Committee on Ways and Means in adopting the Internal Revenue Code of 1954 in the following statement:

[2] The report of the Committee on Finance contains an identical statement; Senate Report 1622, 83d Cong., 2d Sess., p. 26.

> " . . . The depreciation allowances under this method, therefore, are considerably larger in the early years of the life of a property than those resulting from the straight-line method. The declining balance method at twice the appropriate straight-line rate will write off approximately 40 percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life." (House Report No. 1337, 83d Cong., 2d Sess., p. 23)

Clearly Congress in enacting the Internal Revenue Code of 1954 recognized the concept of rapid cost recovery as a means of encouraging plant modernization and growth in productive capacity and specifically provided for methods of depreciation under which most of the cost of a capital asset was recovered within a relatively brief period of time in order to permit a taxpayer to purchase or construct additional facilities.

The decision of the Court of Appeals in this case is consistent with the cost recovery concept underlying the tax depreciation policy of Congress. This decision permits the taxpayer to deduct depreciation on equipment computed in accordance with the life established for such equipment. In this manner through the tax-free recovery of the cost of the equipment, the taxpayer is able to replace such equipment or otherwise increase its productive capacity.

Furthermore, capitalization, or the deferral of depreciation deductions, in an attempt to match such deductions against income earned by the property would be completely inconsistent with the above described Congressional intent. Capitalization of depreciation in the instant case would result in a situation where the entire cost of taxpayer's equipment would not be recovered until 40 years after the

equipment was acquired or 30 years after the end of its useful life. This result would not only deter modernization of, and increases in, plant capacity but would deter the mere replacement of existing capacity.[3]

III.

The decision of the Court of Appeals does not warrant review because there is no real conflict and the issue involved is not of sufficient importance.

This Court has consistently adhered to the policy of granting a Writ of Certiorari only where there is a "real and embarrassing conflict of opinion and authority between the circuit courts of appeal"; *National Labor Relations Board* v. *Pittsburgh Steamship Company,* 340 U.S. 498 (1951); *Layne & Bowler Corporation* v. *Western Well Works, Inc.,* 261 U.S. 387 (1923). In the instant case the Commissioner of Internal Revenue asserts that a conflict exists between the decision below and the decision in *Southern Natural Gas Company* v. *United States,* 412 F.2d 1222 (Ct. Cl., 1969).

In *Southern Natural Gas Company* v. *United States,* the United States Court of Claims merely adopted the decision of its Trial Commissioner. Neither the taxpayer nor the

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[3] It is suggested (Petition, p. 7, n. 6) that capitalization would achieve a "tax parity" between taxpayers constructing their own facilities and those hiring contractors. The Internal Revenue Code has never attempted to arrive at such a balance. For example, a contractor's charges that must be capitalized would include many items which would not be capitalized by a taxpayer constructing assets for its own use, such as interest deductible under section 163, taxes deductible under section 164, a profit element and income taxes on profits. It is clear that depreciation should not be capitalized to create an illusory parity, but instead the express provisions of the Code allowing a deduction for depreciation should be followed.

United States took exception to the Trial Commissioner's finding on the issue involved here.

It is submitted that this decision of the Trial Commissioner as adopted by the Court of Claims is based on three so clearly erroneous assumptions that there is no "real and embarrassing" conflict between the decision in the *Southern Natural Gas* case and the decision below.

First, the Trial Commissioner viewed the issue as one of carving out a special exception to the law for depreciation, stating "No reason is apparent for carving out a special exemption for depreciation." (412 F.2d 1222, 1265) It is clear that the allowance of a deduction for depreciation on equipment used to construct and capital assets does not involve carving out a special exception, but instead is an application of the express language of the Internal Revenue Code as adopted by Congress. It is quite clear that the generalization that all costs of creation of an asset are to be capitalized for tax purposes is not in accordance with the provisions of the Internal Revenue Code. Specific examples of costs not capitalized are the deductions for interest and state and local taxes in sections 163 and 164 (26 U.S.C. 163, 164) of the Code. Similarly, Congress expressly provided for the deduction of a reasonable allowance for depreciation in section 167 and required capitalization under section 263 only of amounts "paid out" or "expenditures". It is submitted that the Trial Commissioner's decision so clearly ignored the express statutory language that there is no real conflict between his decision and that of the Court below.

The second erroneous assumption of the Trial Commissioner was that there would be a double recovery of costs if a taxpayer was permitted to deduct depreciation on

equipment used to construct its own assets, first when the depreciation is deducted and second when the constructed asset is sold (412 F.2d 1222, 1265). As pointed out by the Court below this assumption is "patently incorrect" (477 F.2d 688, 695). If a taxpayer is permitted to deduct depreciation on equipment used to construct a capital asset the basis of the capital asset would not include the depreciation so deducted. Although the taxpayer may be able to sell the property constructed at the same price regardless of whether it constructed property itself or had the property constructed for it, in the former case it would have a larger gain for income tax purposes upon which tax must be paid. From a federal income tax point of view there appears to be no possibility of a double recovery of cost.

The third erroneous assumption of the Trial Commissioner was that if the taxpayer was permitted to deduct depreciation on equipment used by the taxpayer to construct its own assets such assets would be without a tax basis (412 F.2d 1222, 1266). It is submitted that this fear of the Trial Commissioner is without foundation. Unquestionably the Internal Revenue Code permits a deduction of interest and state and local taxes which a taxpayer would not have incurred but for the fact he is engaged in the construction of an asset for his own use. However, the existence of this type of deduction does not leave the taxpayer without a basis for self-constructed assets. Likewise the allowance of a deduction for depreciation of equipment used by a taxpayer to construct an asset for his own use would not lead to the inference that an expenditure incurred in constructing such an asset may be deducted rather than capitalized. A taxpayer's expenditures for labor, materials and other items would be capitalized for

the reason that they fall directly within the scope of section 263 which provides for the capitalization of amounts "paid out" or "expenditures" for capital assets.

It is submitted that the decision of the Trial Commissioner in the *Southern Natural Gas* case was based on three so clearly erroneous assumptions that there is no "real and embarrassing" conflict between the decision below and the decision in the *Southern Natural Gas* case.

It is further submitted that the question presented by this case is not of sufficient importance to warrant review by this Court. The question presented does not involve a taxpayer's ultimate tax liability, but only the timing of such liability. The question is merely whether the taxpayer is entitled to deduct the cost of equipment over the life of the equipment or whether the taxpayer must recover the cost of the equipment over the life of both the equipment and the self-constructed assets.[4] This issue is not of sufficient importance for this Court to review.

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[4] While the Petition (pages 4 and 5) suggests that acceptance of the decision below could result in revenue losses from the electric utility industry of approximately $40,000,000 to be recovered in subsequent years and potentially hundreds of millions of dollars, likewise to be recovered in subsequent years, the magnitude of such figures is clearly misleading. After stating that the taxpayers which would be affected by the decision below are the electric utility industry, railroads, other utilities and major industrial corporations, the Petition states ". . . such taxpayers, in filing their returns, have generally followed a method of depreciation accounting similar to that urged by the Commissioner in this case." From the foregoing statement it is apparent that for such other taxpayers to use the method of depreciation accounting followed by Idaho Power Company, and upheld by the Court of Appeals, a change in method of accounting requiring the Commissioner's consent would be necessary; 26 U.S.C. 446(e). Therefore, there would be no substantial likelihood of large revenue deferrals unless the Commissioner consented.

CONCLUSION

For the foregoing reasons the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

FRANK NORTON KERN
REID & PRIEST
40 Wall Street
New York, New York 10005
Counsel for Respondent

LAWRENCE CHASE WILSON
REID & PRIEST
40 Wall Street
New York, New York 10005
Of Counsel

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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IDAHO POWER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Pet. App. 10-19) are not officially reported; they are unofficially reported at 29 T.C.M. 383. The opinion of the court of appeals (Pet. App. 20-37) is reported at 477 F. 2d 688.

JURISDICTION

The judgment of the court of appeals (Pet. App. 38) was entered on April 10, 1973. On July 5, 1973, Mr. Justice Douglas extended the time for filing a

petition for certiorari to and including August 8, 1973. The petition was filed on that date and was granted on November 5, 1973. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether depreciation on equipment owned and used by a taxpayer in constructing its capital facilities is a nondeductible cost of construction which must be capitalized as part of the adjusted basis of those facilities.

STATUTES INVOLVED

Sections 161, 167, and 263 of the Internal Revenue Code of 1954, 26 U.S.C. 161, 167, and 263, provide in pertinent part as follows:

> Section 161. In computing taxable income * * *, there shall be allowed as deductions the items specified in this part [Sections 161 through 188], subject to the exceptions provided in Part IX (sec. 261 and following, relating to items not deductible).
>
> Section 167(a). There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business * * *.
>
> Section 263(a). No deduction shall be allowed for—
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

STATEMENT

Respondent is a public utility company engaged in the production, transmission, distribution and sale of electric energy.[1] In connection with its principal business, respondent constructs additions and improvements to its capital facilities, using its own employees and equipment. The major construction work consists of additions to or improvements in transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities. During the two years in question, 1962 and 1963, respondent expended over $12,000,000 on construction work of this kind. At the time of the trial in this case, respondent had 140 employees working on new construction.

In performing this construction work, respondent used a wide variety of automotive transportation equipment, including passenger cars, trucks of all description, power operated equipment and trailers, and so forth. For its general accounting purposes, including reporting to regulatory agencies responsible for ratemaking and other related determinations, respondent treated the depreciation on this equipment, to the extent it was used in construction, as part of the cost of the capital facilities so constructed. Thus for accounting purposes the depreciation was capitalized and then amortized over the life of

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[1] The facts recited herein are taken from the Tax Court's memorandum findings of fact (Pet. App. 10-13).

the capital facilities.[2] For tax purposes, however, respondent treated this construction-related depreciation not as a capital expenditure but as a currently deductible item of expense. The amount of depreciation here at issue is $150,047.42 for 1962 and $130,523.99 for 1963.

The Commissioner determined that the construction-related depreciation on respondent's equipment was a nondeductible capital expenditure under Section 263 of the Internal Revenue Code of 1954, 26 U.S.C. 263, and adjusted respondent's federal income tax returns accordingly. He disallowed deductions for construction-related depreciation, added the amount of the disallowed depreciation to respondent's adjusted basis in its capital facilities, and allowed additional depreciation with respect to those facilities on account of the increase in their adjusted basis. The net effect of these adjustments was to increase respondent's tax liability for 1962 by $73,023.47 and for 1963 by $50,342.21.

The Tax Court sustained the Commissioner's determination (Pet. App. A). The court of appeals reversed (Pet. App. B), apparently reasoning that Section 263 of the Code does not apply to items spe-

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[2] Respondent also capitalized substantially all the costs of operating and maintaining the construction equipment, including the wages paid to operators, the cost of fuel, and so forth, as well as the wages of other construction employees and the cost of tools and other materials wholly consumed in the course of construction. Respondent does not contest the propriety of treating these items as nondeductible capital expenditures for tax purposes.

cifically made deductible by other Code provisions and that, in any event, construction-related depreciation is not the kind of capital expenditure which Section 263 requires to be capitalized.

SUMMARY OF ARGUMENT

1. Both good accounting practice and basic tax accounting principles require that the costs incurred in acquiring a long-lived, income-producing asset be capitalized rather than taken as a current deduction. Immediate deduction of such costs would seriously distort the reporting of income. Capitalization, together with amortization over the asset's useful life, permits a reasonable allocation of the asset's cost over the periods during which it contributes to the production of income.

Capitalization of asset acquisition costs is required whether the asset is purchased or constructed by the taxpayer itself. Since the depreciation incurred on construction equipment is part of the cost of constructing a new capital facility, normal accounting rules require capitalization of that depreciation. The reason for this is that such depreciation is not related to the immediate production of income, but only to the production of income over the life of the newly constructed asset. Respondent, in claiming an immediate deduction for such depreciation, is in effect contending that it is permitted under the Internal Revenue Code to postpone the recognition of net income earned currently by taking, as a deduction against such income, an item of depreciation expense

to which it is not entitled under normal accounting rules. That contention may be sustained only if supported by compelling statutory language or fundamental considerations of tax policy. There is no such support for respondent's position.

2. The statutory provisions governing this case are Section 263, embodying the principle of capitalization, Section 167, allowing a deduction for depreciation, and Section 161, which gives Section 263 priority over Section 167 whenever those two provisions otherwise appear to conflict.

a. The court of appeals below erred in holding that Section 263 only applies to capital items whose deductibility is not allowed under some other express provision of the Code. Section 161 provides in clear terms that all business-related deductions, including the deduction for depreciation, are subject to, *inter alia*, the capitalization requirement of Section 263. The court of appeals simply overlooked the mandatory language of Section 161.

The priority ordered by Section 161 is not accidental. That priority—which requires capitalization of depreciation incurred in connection with the acquisition of capital assets—merely insures that the tax and accounting treatment of such depreciation will be alike. Moreover, Congress has often manifested its awareness that construction-related depreciation is nondeductible under the Code, and it has taken care, in amending Section 263, to make only narrow exceptions to that broad rule.

b. Section 263 expressly prohibits a deduction for any "amount paid out for new buildings or for per-

manent improvements or betterments * * *." The court of appeals below held that construction-related depreciation is not an "amount paid out" within the meaning of that provision. This holding exhibits a fundamental misunderstanding of the purpose of Section 263. That purpose is to state the broad principle that capital expenditures may not be deducted currently; Section 263 must therefore be read expansively as the legislative expression of the basic principle of capitalization. The Internal Revenue Service and the courts charged with special responsibility for interpreting and applying the federal tax laws have long applied that principle to construction-related depreciation.

Furthermore, depreciation clearly represents an "amount paid out." When respondent purchased its construction equipment, amounts were paid out; depreciation allocates those amounts over several accounting periods. Depreciation, therefore, stands on the same footing as other costs which were actually paid out in an earlier or later year—like the cost of materials purchased in an earlier year but wholly consumed by construction activities during the taxable year, or the cost of construction workers' wages accrued but not yet paid during the taxable year. Section 263 makes no reference to the timing of actual payment; the emphasis of the statute is on the ultimately capital nature of the expenditure. Thus cases disallowing depreciation under Sections 170 and 213, which require payment "during the taxable year," are irrelevant to the issue here.

ARGUMENT

DEPRECIATION ON EQUIPMENT OWNED AND USED BY A TAXPAYER IN CONSTRUCTING ITS CAPITAL FACILITIES IS A NONDEDUCTIBLE COST OF CONSTRUCTION WHICH MUST BE CAPITALIZED AS PART OF THE ADJUSTED BASIS OF THOSE FACILITIES.

1. Normal Accounting Rules and Elementary Principles of Federal Tax Accounting Require Capitalization of Construction-Related Depreciation.

a. *Introduction.* This case raises an important question concerning the proper application of two fundamental and interrelated accounting concepts, capitalization and depreciation, under the Internal Revenue Code of 1954. Together, capitalization and depreciation govern the accounting treatment of long-lived, income-producing assets. The purpose of capitalization is to prevent the distortion in the reporting of net income which would result from permitting the immediate deduction, as an expense of doing business, of the acquisition costs of assets used for the production of income in two or more accounting periods. Thus, for example, when respondent purchases automotive equipment the purchase price is capitalized on its books.

As assets are physically used up they typically become less valuable. The physical "using up" of an asset constitutes a real cost to a business, for part of its capital is being consumed. Depreciation is an accounting device which recognizes this cost by reducing the basis of the asset on the business' books as it is used up. The amount by which the asset basis is reduced—*i.e.*, the depreciation—is normally taken as an

expense against income. Indeed, the major purpose of depreciation accounting is to allocate the expense of using up an asset to the accounting periods during which that use is associated with the production of income. Thus the taking of an immediate expense deduction for depreciation is proper where the using up of the asset has contributed to the production of current income.

Assets are not always used, however, for the immediate production of income. Our position in this case is that where the using up of assets, or depreciation, is incurred not for the immediate production of income but instead for the construction of additional assets which will themselves be used for the production of income in the future, a deduction of the depreciation against current income is inappropriate. The physical using up of the equipment is not a cost of producing current income; it is a cost of constructing a capital facility.

Both respondent and the government agree that the adjusted basis of respondent's construction equipment should be reduced on account of depreciation. But unlike respondent, we believe that the amount of the depreciation should be added to the adjusted basis of the capital facilities respondent builds with that equipment and should not be taken as an immediate deduction.[3] We now discuss in greater detail the economic

[3] An example may make this proposition clearer. Assume respondent purchases a truck having a useful life of five years at a cost of $10,000 and that the straight-line method of depreciation is employed. Assume further that during the first year the truck is used exclusively in construction work.

and accounting considerations which underlie our position here.

b. *Underlying economic and accounting considerations support the government's position in this case.* Both good accounting practice and elementary principles of federal tax accounting require capitalization of the cost incurred in acquiring long-lived, income-producing assets. As this Court noted in *Woodward* v. *Commissioner*, 397 U.S. 572, 575, "[i]t has long been recognized * * * that costs incurred in the acquisition * * * of a capital asset are to be treated as capital expenditures." While this principle is most frequently applied to the purchase of a capital asset, capitalization is also required when costs are incurred by a business in constructing its own capital facilities. Indeed, it has long been established under the federal tax laws that a taxpayer's construction costs must be capitalized and are not immediately deductible when incurred. See, *e.g.*, *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225, 260-263, affirmed, 40 F. 2d 372 (C.A. 8), certiorari denied, 282 U.S. 855. See, also, 26 C.F.R. 1.263(a)-2(a).

The application of this general principle is clear with respect to expenditures such as wage payments to construction workers and the purchase cost of construction materials. Although wages are normally deductible as items of expense, they must be capital-

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Respondent and the government agree that a depreciation allowance of $2000 is appropriate, reducing the adjusted basis of the truck to $8000. Respondent would deduct that $2000 allowance against current income; we would add it to the adjusted basis of the facility under construction and permit it to be amortized as an expense over the useful life of that facility.

ized when they are paid in connection with the construction or other acquisition of capital assets. The reason for this treatment is evident: the money expended in the payment of construction wages is not an expense associated with the current production of income; it is an investment in an asset which will be used to produce income in the future, and therefore must be allocated as an expense over future accounting periods. Other construction expenditures which might at first blush be regarded as normal operating expenses, such as the cost of operating and maintaining construction equipment, must also be capitalized. Respondent and the government are in general agreement with respect to the proper accounting and tax treatment of such items (see note 2, *supra*).

But good accounting practice also requires capitalization of certain other intangible construction costs, including the allowance for the wear and tear, or depreciation, of the equipment used in the course of construction. See, *e.g.*, Paton, *Asset Accounting: An Intermediate Course* 192-193 (1st ed.); Finney & Miller, *Principles of Accounting—Introductory* 246-247 (6th ed.). As we indicated above, depreciation recognizes the cost of using up an asset; construction equipment is used up, and a cost thereby incurred, during construction. Construction-related depreciation represents that cost and as such it is simply one more item of cost incurred in acquiring a particular capital facility. Such depreciation therefore does not represent an expense of doing business; it is, rather, the transfer of an investment in equipment into an

investment in plant facilities. This fact is properly accounted for on a business' books by capitalizing construction-related depreciation, *i.e.*, by reducing the equipment account, and increasing the capital facility account, by the amount of the depreciation. In this sense, capitalization is necessary as a matter of proper asset accounting.

But, more importantly, capitalization of construction-related depreciation is also necessary to prevent the improper reduction of net income which would result from the deduction of an item of expenditure that is not associated with the current production of income. The basic purpose of depreciation accounting is to "allocate the expense of using an asset to the various periods which are benefited" by its use. *Hertz Corp.* v. *United States*, 364 U.S. 122, 126. Thus, for example, if automotive equipment is used in connection with the immediate production of income, as in hauling goods to the market, the depreciation on that equipment is properly deductible when incurred. But if that automotive equipment is used instead in the construction of capital facilities, its use renders no income-producing benefit to the immediate accounting period. Like the cost of wage payments to construction workers, construction-related depreciation is associated with the production of income not when it is incurred but only over the useful life of the newly constructed capital facility.

Thus the periods benefited by a business' use of equipment to construct its own capital facilities are those during which the facilities so constructed are

themselves used for the production of income. The proper matching of items of income and expense is therefore achieved only by capitalizing construction-related depreciation as part of the cost of the new capital facilities and then amortizing that cost over the life of those facilities.

For these reasons, both the Federal Power Commission and the Idaho Public Utilities Commission require respondent to capitalize construction-related depreciation in its reports to them, and respondent keeps its own books on the same basis (Pet. App. 12, 22). Moreover, respondent apparently concedes that this procedure is required by generally accepted accounting principles (Resp. Br. in Opp. 6). Respondent contends that it is nevertheless entitled to an immediate deduction of construction-related depreciation under the Internal Revenue Code. Viewed in context, therefore, respondent's contention is that it is permitted under the Code to defer the recognition of net income by taking a depreciation deduction to which it is not entitled under normal accounting rules.

In making this contention, respondent apparently suggests (Resp. Br. in Opp. 6) that general principles of accounting are irrelevant to the concept of taxable income under the Code. But Section 446 of the Code, which requires taxable income to be computed under a method of accounting that "clearly reflect[s] income," implicates accounting principles. See, also, Sections 441(c) and 461(a). Moreover, this Court noted in *Commissioner* v. *Lincoln Savings*

& Loan Ass'n, 403 U.S. 345, 355, that a taxpayer's own accounting practices and those of its regulating authority are significant in assessing the proper tax treatment to be given a transaction.

This is not, of course, to say that the determination of taxable income is governed in all cases by accounting principles. Many provisions of the Code expressly permit or require a deviation from such principles. In other circumstances, overriding considerations of tax policy have led this Court to interpret "income," as used in the Code, in a manner apart from its meaning to accountants.

Thus in *Schlude* v. *Commissioner*, 372 U.S. 128, and *American Automobile Association* v. *United States*, 367 U.S. 687, this Court held that a taxpayer may not defer the reporting of cash receipts as gross income, even if those receipts were not yet income in an accounting sense. In those cases, the taxpayers had untrammeled possession of monies held without restriction as to their disposition and without liability for repayment. In holding the receipt of such monies to be taxable, this Court gave due recognition to the fact that Congress intended, in defining gross income, "to use the full measure of its taxing power." *Helvering* v. *Clifford*, 309 U.S. 331, 334. See, also, *James* v. *United States*, 366 U.S. 213; *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426; *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417. Similarly, though accounting practice in many cases sanctions, or even requires, the anticipation of losses or expenses by the establishment of reserves, such uncertain and unascertained items are not deductible

for tax purposes (*e.g.*, *Brown* v. *Helvering*, 291 U.S. 193), except where specifically authorized by statute.

But where neither compelling statutory language, fundamental tax policy considerations, nor practical necessities of administration require otherwise, the process of income-determination under the Code is generally informed by normal accounting rules. See, *e.g.*, *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*; *Commissioner* v. *Hansen*, 360 U.S. 446. Certainly this is true where, as in the case of construction-related depreciation, normal accounting rules accurately reflect economic substance and would require postponement in the taking of a deduction. A strong showing of unambiguous statutory authority should be required of a taxpayer who claims the right to defer the recognition of net income by taking a current deduction not sanctioned by normal accounting rules. As we now demonstrate, there is no such authority for the deduction respondent here claims.

2. Capitalization of Respondent's Construction-Related Depreciation Is Required by Section 263 of the Code.

The accounting principles of capitalization and depreciation are represented in the Internal Revenue Code by Sections 263 and 167, respectively. Section 263 provides that "[n]o deduction shall be allowed for * * * [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Thus Section 263 prohibits an immediate deduction for the costs of assets having a useful life of more than one year and thereby prevents a taxpayer from anticipating deductions properly attribu-

table to the later years when the assets are used in the production of income. Section 167 permits the deduction of a "reasonable allowance for the exhaustion, wear and tear" of property arising out of its use or employment in the business. Thus Section 167 provides for a reasonable allocation, over subsequent taxable years, of the cost which Section 263 requires to be capitalized in the first year.

a. *Section 263 governs transactions to which both it and Section 167 by their literal terms apply.* When depreciable equipment is used in the construction of capital facilities, Sections 263 and 167, read in isolation, appear to point to conflicting tax results. Section 263 requires capitalization of the "cost of acquisition, construction, or erection of buildings * * * and similar property * * *." Treasury Regulations, 26 C.F.R. 1.263(a)-2(a). Since construction-related depreciation is a cost of construction, Section 263 points to nondeductibility. On the other hand, Section 167 by its terms would appear to allow a deduction for any depreciation on income-producing property, whether or not construction-related. The court of appeals resolved this apparent conflict in favor of immediate deductibility, holding that Section 263 does not bar deductions specifically allowed elsewhere in the Code.[4]

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[4] The court's holding, if pursued to its logical conclusion, would appear to permit the deduction of all construction-related expenses, including wages paid to construction workers, for Section 162 specifically permits the deduction of ordinary and necessary business expenses, including wages. Presumably the court did not intend that result. But its analysis of the statutory text offers no reason why Section

That holding is contrary to the explicit language of the statute. Congress has stipulated, in unmistakable terms, the manner in which the apparently conflicting provisions of Sections 263 and 167 are to be reconciled: Section 161 makes all business-related deductions, including the deduction for depreciation under Section 167, "subject to the exceptions provided in [Sections 261 through 279]." Thus whenever Sections 263 and 167 appear to point to conflicting results, it is Section 263 which controls. In holding otherwise, the court below simply overlooked the plain language of Section 161.

In holding that Section 263 is inapplicable to deductions otherwise specifically allowed by the Code, the court of appeals relied solely on *All-Steel Equipment, Inc.* v. *Commissioner*, 54 T.C. 1749, reversed in part, 467 F. 2d 1184 (C.A. 7). In that case, the Tax Court held that taxes, losses, and research and experimental expenses incurred in producing items for inventory are currently deductible and need not be capitalized as part of the cost of inventory.[5] We do not here dispute the correctness of that result. Section 263(a)(1)(B) exempts research and experimental expenses from the broad capitalization re-

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263 would bar business expense deductions under Section 162 but not depreciation deductions under Section 167.

[5] The Tax Court also held that certain repair expenses incurred in producing inventory could be currently deducted rather than included in inventory cost as contended by the Commissioner. The court of appeals reversed that determination, holding (467 F. 2d at 1186) that the repair expenses could be deducted "only in the taxable year in which the manufactured goods to which the repairs relate are sold."

quirement of that Section; Section 266 creates a further exception to Section 263 by granting taxpayers the option of either capitalizing or deducting taxes otherwise attributable to a capital account; and the Treasury Regulations (26 C.F.R. 1.61-3(a)) have long provided that losses are not properly includible in inventory.

We do, however, disagree with the Tax Court's broad statement in that case that "deductions expressly granted by statute [*i.e.*, Sections 164, (taxes), 165 (losses), and 174 (research costs)] are not to be deferred even though they relate to inventory or capital items." 54 T.C. at 1759. That statement is inconsistent not only with Section 161, which expressly makes Sections 162-188 subordinate to Sections 261-279, but also, of course, with the subsequent decision by the Tax Court in the present case. See, also, *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (involving capitalization of expenditures which the taxpayer sought to deduct as interest payments under Section 163). Like the court of appeals below, the Tax Court in *All-Steel Equipment* simply overlooked Section 161.

Moreover, the language of Section 161, as it bears upon construction-related depreciation, is not a product of inadvertence. The priority ordered by Section 161 accords with generally accepted accounting principles. Furthermore, Congress has often manifested its awareness that construction-related depreciation is nondeductible under the Code.

For example, in recommending enactment of Section 263(a)(1)(E), permitting the deduction of

farmers' land-clearing expenditures, the Senate Finance Committee noted that under the new Act, farmers would be permitted to deduct "a reasonable allowance for depreciation with respect to property which is used in the clearing of land for the purpose of making such land suitable for use in farming * * * [whereas] [u]nder present law such depreciation must be capitalized." S. Rep. No. 1881, 87th Cong., 2d Sess. 338. In enacting Section 263(a)(1)(B), permitting the deduction of research and experimental expenditures, and the predecessor of Section 263(a)(1)(A), permitting the deduction of certain expenditures incurred in the development of mines or deposits, Congress also expressed its intention of granting only narrowly limited exceptions to the general rule that construction-related depreciation is nondeductible. See H. Rep. No. 1337, 83d Cong., 2d Sess. 28, A57-A59; H. Rep. No. 586, 82d Cong., 1st Sess. 31.

Congress, then, has long been aware that the language of the Code requires capitalization of construction-related depreciation. It is therefore highly significant that Congress, in creating certain exceptions to the broad requirement that capital costs be capitalized (see, *e.g.*, Section 263(a)(1)(A)-(E), (c) and (d), and Section 266), has chosen not to enact such an exception for construction-related depreciation generally. The court of appeals below has therefore sanctioned an immediate deduction not allowed by normal accounting rules, and consequently a deferral in the recognition of taxable income, which the Congress has steadfastly refused to permit.

The court purported to draw support for this result from the 1954 liberalization of tax depreciation rules under Section 167. But those liberalized rules, which permit the adoption of methods of accelerated depreciation accounting, are not at issue here; there is no question here concerning the amount of depreciation properly chargeable to respondent's construction equipment. The issue here is simply whether that depreciation is currently deductible or must be capitalized as a cost of construction.

In adopting liberalized depreciation rules, Congress was not sanctioning the deductibility of depreciation which Section 263 requires to be capitalized. Had that been the Congressional purpose, it could have easily manifested that purpose by proper amendment to Section 263; that, however, is precisely what Congress has refused to do. Moreover, in designing liberalized depreciation rules, Congress intended only to "give the economy added stimulus and resilience *without departing from realistic standards of depreciation accouting.*" H. Rep. No. 1337, 83d Cong., 2d Sess. 24 (emphasis added). As we have shown (pp. 10-15, *supra*), normal accounting rules, including "realistic standards of depreciation accounting," require the capitalization of construction-related depreciation.

b. *Construction-related depreciation is an "amount paid out" within the meaning of Section 263.* The court of appeals alternatively reasoned that construction-related depreciation is not an "amount paid out" within the meaning of Section 263. Apparently the court read Section 263 as requiring capitalization

only of actual transfers of funds taking place within the taxable year. This reading is wrong for several reasons.

At the most fundamental level, that narrow reading of the statute exhibits a basic misunderstanding of the purpose of Section 263. That purpose is to state the broad principle of capitalization, *i.e.*, that capital expenditures may not be immediately deducted. Section 263 therefore is not a technical section to be read narrowly. If its purpose is to be fairly achieved, Section 263 must be read expansively as the legislative expression of the principle of capitalization.*

This is the long-standing administrative construction of the statute: the Treasury Regulations state broadly that nondeductibility under Section 263 extends to the "*cost* of acquisition." 26 C.F.R. 1.263

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*This Court in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, suggested alternatively that where Section 263 by its literal terms might not apply, the principle of capitalization—deeply rooted in a tax system which requires accounting methods to "clearly reflect income" (Section 446)—would nevertheless bar a deduction. At least in this case, that analysis produces the same result as the expansive reading of Section 263 which we urge here. Both approaches reflect the view that accounting principles and economic substance should govern the capitalization question in the absence of clear statutory authority or fundamental tax policies to the contrary. For that reason, we also agree that even capital items which could not fairly be characterized as "amount[s] paid out" are nevertheless nondeductible and must be capitalized—that, in short, as this Court stated in *Lincoln Savings* (403 U.S. at 358), Section 263 "does not provide a complete list of nondeductible expenditures." However, we need not reach that question in this case for, as we proceed to show, construction-related depreciation is in fact an "amount paid out" for purposes of Section 263.

(a)-2(a) (emphasis added). This expresses the administrative understanding that the statutory phrase "amount paid out" is used synonymously with "cost incurred." Moreover, the Internal Revenue Service has consistently taken the position that construction-related depreciation must be capitalized and is not immediately deductible. See Rev. Rul. 59-380, 1959-2 Cum. Bull. 87; Rev. Rul. 55-252, 1955-1 Cum. Bull. 319. This position has been consistently sustained by those courts charged with a special responsibility for interpreting and applying the federal tax laws. *Coors* v. *Commissioner*, 60 T.C. 368; *Southern Natural Gas Co.* v. *United States*, 412 F. 2d 1222 (Ct. Cl.); *Producers Chemical Co.* v. *Commissioner*, 50 T.C. 940; *Brooks* v. *Commissioner*, 50 T.C. 927, reversed on other grounds, 424 F. 2d 116 (C.A. 5); *Missouri Pacific R. Co.* v. *Commissioner*, 22 B.T.A. 267; *Gulf, M. & N.R. Co.* v. *Commissioner*, 22 B.T.A. 233, affirmed as to other issues, 71 F. 2d 953 (C.A.D.C.); *Chicago, R.I. & P. Ry. Co.* v. *Commissioner*, 13 B.T.A. 988, reversed as to other issues, 47 F. 2d 990 (C.A. 7); *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225, affirmed, 40 F. 2d 372 (C.A. 8), certiorari denied, 282 U.S. 855.[1]

But even if the statutory phrase "amount paid out" were given its most literal construction, the cost

[1] The court of appeals below cited *Great Northern Ry. Co.* v. *Commissioner*, 30 B.T.A. 691, as permitting a current deduction for construction-related depreciation. In that case, however, the Commissioner had not argued that the construction costs should be capitalized. 30 B.T.A. at 708. See Pet. App. 17-18.

of the automotive construction equipment used by respondent was "paid out" to the same extent as the cost of all other supplies and equipment and the wages of construction workers. Respondent properly has never claimed that it could deduct, rather than capitalize, the cost of materials purchased in one year but wholly consumed in construction activities during another. Yet construction-related depreciation stands on precisely the same footing.

When respondent purchased its automotive construction equipment, amounts were "paid out" in the form of a purchase price; depreciation is simply a means of allocating those amounts over several accounting periods. The only question here is whether those amounts, to the extent allocable to construction activities, should be capitalized as part of the costs of construction. That question is answered by the language of the statute; "[a]ny amount paid out" in connection with the acquisition or construction of capital facilities must be capitalized, and the amounts represented by construction-related depreciation were paid out, in a very real sense, for the construction of such facilities. As the Tax Court stated in *Brooks* v. *Commissioner*, *supra*, 50 T.C. at 935, "depreciation—inasmuch as it represents a using up of capital —is as much an 'expenditure' as the using up of labor or other items of direct cost."

In concluding that depreciation does not represent amounts paid out within the meaning of Section 263, the court of appeals incorrectly relied upon cases disallowing deductions for depreciation under Sections 170 and 213, relating to charitable contribu-

tions and medical expenses.[8] Section 263 makes no reference to the timing of the actual payment; the emphasis of that statute is on the ultimately capital nature of the expenditure. But in enacting deductions for charitable contributions and medical expenses, Congress was obviously concerned primarily with cash-basis taxpayers and actual outlays of cash or other property. Thus Section 170 allows a deduction only for a "charitable contribution * * * *payment of which is made within the taxable year*" (emphasis added), and Section 213 limits the medical deduction to "expenses *paid during the taxable year*" (emphasis added). This insistence upon actual payment during the particular year is inconsistent with a purpose of allowing a deduction for depreciation, which represents not a current payment but an allocation on account of an amount previously paid.[9] Thus the Tax Court in *Producers Chemical Co.* v. *Commissioner*, *supra*, 50 T.C. at 959, involving depreciation incurred in connection with the acquisition of a capital asset, distinguished the medical expense case relied upon by respondent here (see note 8, *supra*) in the following terms:

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[8] The court cited *Orr* v. *United States*, 343 F. 2d 553 (C.A. 5) (charitable contribution), *Mitchell* v. *Commissioner*, 42 T.C. 953 (charitable contribution), and *Gordon* v. *Commissioner*, 37 T.C. 986 (medical expense).

[9] Of course, depreciation taken during the year of purchase does represent an amount paid during that year. But Congress may not be supposed to have capriciously intended Sections 170 and 213 to create a special allowance for depreciation limited solely to the year of purchase.

> [In that case, we] held that the deduction for medical expenses was for such expenses paid in the year for which the deduction was claimed and concluded that depreciation was not an expense paid in the year in issue. That case has no relevance to the issue in the instant case.

Moreover, Congress in Section 167 has restricted the depreciation deduction to income-producing assets. The courts therefore have properly resisted efforts by taxpapers to obtain deductions for depreciation on nonincome-producing assets under color of Sections 170 and 213.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

KEITH A. JONES,
Assistant to the Solicitor General.

ELMER J. KELSEY,
MICHAEL L. PAUP,
Attorneys.

JANUARY 1974.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1975 529529 142

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

IDAHO POWER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

FRANK NORTON KERN
LAWRENCE CHASE WILSON
Counsel for Respondent
Reid & Priest
40 Wall Street
New York, New York 10005

February 1974

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

IDAHO POWER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

Question Presented

Whether depreciation on equipment owned and used in part by a taxpayer in constructing its capital facilities may be deducted over the lives of the equipment or must be capitalized as part of the adjusted basis of the facilities constructed?

Statement of the Case

The statement of the facts in the government's brief in this case omits the following relevant facts:

1. The transportation equipment, the depreciation of which is in issue here, was used by the taxpayer

not merely for construction but also in operations and maintenance (Stip. ¶ 6, App. 12)[1].

2. This equipment was depreciated for tax purposes over a composite life of ten years (Stip. ¶ 7, App. 12) and the facilities which such equipment was in part used to construct had useful lives of 30 years or longer (Stip. ¶ 9, App. 13).

3. For tax purposes, to the extent transportation equipment was used in the construction of capital assets taxpayer capitalized all costs of operating and maintaining such equipment, except pension contributions, social security taxes, motor vehicle taxes and depreciation. The government and taxpayer are in agreement that it was proper for taxpayer to deduct currently the pension contributions, social security taxes and motor vehicle taxes (Stip. ¶ 14, App. 19).

Summary of Argument

The taxpayer used its own mobile equipment having a 10 year life, including trucks and specialized equipment, in part for operations and maintenance and in part for the self-construction of facilities having lives in excess of 30 years. The question is whether for federal income tax purposes the taxpayer may deduct depreciation on the equipment over its 10 year life or must capitalize an allocable portion of the depreciation as part of the adjusted basis of the facilities constructed thereby requiring that the deduction for depreciation be spread over a period of more than 40 years which includes the useful lives of both the equipment and the facilities constructed.

This question is to be resolved by the intention of Congress in enacting sections 167 and 263 of the Internal Reve-

1. App. refers to the Joint Appendix provided for under Rules 35 and 36.

nue Code and their statutory predecessors. Under section 167 a taxpayer is allowed as a depreciation deduction an allowance for the "exhaustion, wear and tear . . . of property used in the trade or business". It is conceded that taxpayer's equipment is depreciable and, there is no issue in the instant case as to whether depreciation on such equipment is an allowable deduction under section 167 unless this deduction is precluded by reason of another provision in the Internal Revenue Code.

Historically section 263 of the Internal Revenue Code has disallowed deductions for "[a]ny amount paid out for new buildings or for permanent improvements or betterments" which language was first adopted as part of a Civil War income tax act. In 1951, the word "expenditures" was added as the equivalent of "amount paid out". When the basic provision of section 263 was first enacted in 1864 it was clearly not intended by Congress to disallow a deduction for depreciation as the concept of depreciation had not yet been recognized in the United States. When this language was used by Congress in the Tariff Act of 1909 and in the Tariff Act of 1913, the predecessors of the present Internal Revenue Code, Congress manifested an understanding that the deduction for depreciation was the equivalent of a loss or reduction in the value of property as used rather than an amount paid out. This understanding of Congress as to the nature of depreciation has continued up to the present time and has been recognized in court decisions and in Treasury Regulations.

In light of the understanding of Congress that depreciation is a reduction in value of property, throughout the history of the Internal Revenue Code whenever Congress has had occasion in a particular section of the Code to treat depreciation as being the equivalent of an amount paid or expenditure it has expressly so provided. This

treatment has been uniformly followed in the case of the deduction for depreciation but has not been applied in the case of any other deduction. For example, in sections 174, 182, 615, 616 and 617 in which taxpayers are given the right to elect under various circumstances to deduct or capitalize expenditures, Congress has in each case provided that "allowances for depreciation shall be considered, for purposes of this section, as expenditures paid or incurred" or equivalent language. On the other hand, when Congress has not intended depreciation to be treated as a payment or amount paid, as in section 170 concerning charitable contributions and section 213 concerning deduction of medical expenses, it has included no comparable provision. Congress has never provided that depreciation shall be considered an amount paid or an expenditure in section 263. In light of the care Congress has taken throughout the Internal Revenue Code to define or designate depreciation as an expenditure when it is intended to be treated as such, it is apparent that Congress has continued the intention of previous Congresses which first enacted the statutory predecessors of section 263 that depreciation should not be considered an amount paid out or an expenditure under this section.

That Congress has not provided that the terms amount paid or expenditure shall include depreciation in section 263 and, as a consequence, has not required the capitalization of depreciation on equipment used by the taxpayer to construct its facilities, is consistent with the Congressional intent concerning the deduction for depreciation. The basic purpose of Congress in allowing such deduction has been to permit a taxpayer to recover free of tax its investment in capital equipment over the life of such equipment in order that the taxpayer will have available funds to replace it. Congress recognized American business must replace

equipment with modern higher cost equipment to maintain its efficiency and compete with businesses throughout the world and has placed increased emphasis upon the concept of tax-free recovery of cost. This was reflected in 1954 when Congress enacted the Internal Revenue Code of 1954 which permitted taxpayers to use accelerated methods of depreciation under which a taxpayer could recover 40 percent of the cost of an asset in the first quarter of its useful life and two-thirds of the cost in the first half of its life. This increased emphasis on cost recovery was further highlighted when Congress provided at section 167(m) of the Code for the class life method of depreciation under which useful lives were to be established on the basis of shorter lives than the average lives claimed by taxpayers and taxpayers were permitted to reduce these shorter lives by 20 percent.

The importance of permitting the taxpayer to recover free of tax its cost of capital equipment is equally applicable to equipment used by the taxpayer to construct its own facilities. It is just as important for a taxpayer who uses equipment in self-construction to be permitted tax-free recovery of the cost of such equipment over its life in order that it may be replaced with modern equipment as it is for taxpayers who use equipment for maintenance or production. In this respect equipment used in self-construction of facilities differs from expenditures for labor, materials and similar expenditures that become part of the facilities for these expenditures need not be replaced until the end of the useful lives of the facilities and their cost may be recovered over such lives.

The government urges that under section 161 the deduction for depreciation is subordinate to section 263. However, section 161 is merely a housekeeping section which provides that the deductions allowed under sections 162

through 188 are subject to the exceptions provided at sections 261 through 279. In adopting section 161 in 1954 Congress neither limited its intention concerning the scope of the deductions in sections 162 through 188 nor expanded its intention concerning the scope of the exceptions provided in sections 261 through 279.

The government argues that depreciation on taxpayer's equipment should be capitalized under the financial accounting concept of matching expenses with income. However, tax accounting for depreciation is not based on the concept of matching expense with income. It has long been held that depreciation must be deducted in the year in which it is properly incurred regardless of whether it contributes to the production of income in such year and regardless whether the depreciable equipment was in use or idle in such year. In its emphasis on the deduction for depreciation as a means for tax-free recovery of cost over the early portion of the life of the property in order to provide taxpayer with funds to replace and modernize equipment, Congress has clearly indicated its understanding that cost-recovery rather than matching deductions against income is the controlling principle in allowing depreciation.

The government also urges that under financial concepts of cost the depreciation of equipment used in the self-construction of facilities should be capitalized as a part of the cost thereof. Cost is nowhere defined in the Internal Revenue Code or Treasury Regulations. However, it is clear that general financial or economic concepts of cost are not controlling for tax purposes. For example, interest and state and local taxes incurred in connection with the construction of capital assets have never been required to be capitalized even though economically they represent a part of the cost of self-constructed facilities. The government has expressly recognized this principle in the instant case

by allowing taxpayer to deduct social security taxes, motor vehicle taxes and pension contributions incurred in connection with the construction of its facilities. The provisions of the Internal Revenue Code, and not general concepts of cost, govern the allowance of depreciation.

Depreciation on taxpayer's equipment used in the self-construction of facilities is an allowable deduction under section 167 and is not subject to the exception provided at section 263. This depreciation should be allowed under the express statutory provisions of the Internal Revenue Code in accordance with the intention of Congress.

Argument

I.

Sections 167 and 263 of the Internal Revenue Code rather than financial concepts of accounting or cost determine whether depreciation on equipment owned by a taxpayer and used in part to construct its facilities is to be deducted over the useful life of the equipment or capitalized.

A. Financial accounting concepts do not reflect the practical treatment by Congress of depreciation as a means of recovering cost.

The taxpayer used various types of equipment such as passenger cars, specially equipped trucks, cranes and backhoes in part for operations, in part for maintenance and in part for construction of facilities. Taxpayer deducted depreciation on this equipment over its useful life of 10 years. To the extent that the equipment is used in construction of facilities the government would require that

depreciation be deducted over the period of 10 years plus the useful lives of 30 or more years of the facilities constructed or a total of at least 40 years.[2]

Both the government and the taxpayer are in agreement that section 167 of the Internal Revenue Code would permit the taxpayer to deduct depreciation over the 10 year life of the equipment if it were not used in construction (Pet. Br. 9).[3] The sole issue in dispute is whether section 263 by its terms requires capitalization of depreciation where the taxpayer uses its own equipment to construct its facilities.

As support for its view that such depreciation must be capitalized, the government asserts that matching the deduction of depreciation against the production of income is the basic principle controlling the timing of such deduction and that to achieve this purpose the deduction should be deferred until long after the equipment is no longer in existence (Pet. Br. 9).

However, the legislative history of the federal income tax laws indicates that the primary purpose of Congress has been to provide through the deduction for depreciation a "method by which the capital invested in an asset is recovered tax-free over the years it is used in a business." H. Rep. No. 1337, 83d Cong., 2d Sess., 22; see also *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960); *United States* v. *Ludey*, 274 U.S. 295, 300 (1927). The taxpayer must have funds to replace his equipment with new and efficient equipment when its useful life terminates.

2. Depreciation applicable to the last year in which the equipment is used in construction would be deducted in the last year in which the constructed facilities are depreciated.

3. Pet. Br. refers to the Brief for the Petitioner.

There has never been a requirement that the deduction for depreciation must match the production of income.[4] Moreover, in the legislative history of section 167, Congress has placed increased emphasis on its purpose of providing for recovery of cost of capital equipment and has over the years given little credence to any concept of matching the deduction for depreciation against income.

The tax-free recovery of the cost of a capital asset has been accomplished by Congress through the allowance of depreciation without limitation over the useful life of property used in business by section 167 and its statutory predecessors. Section 263 of the Internal Revenue Code and its statutory predecessors which set forth the requirements for capitalization would conflict with this concept of cost recovery only if they required capitalization of depreciation and they have not so required.

The concept adopted by Congress of deduction of depreciation as a means of tax-free recovery of capital investment is equally applicable to taxpayer's equipment used to construct its facilities. The equipment itself represents a capital investment that is being consumed as the equipment is used and the taxpayer must acquire funds over the equipment's useful life to replace it. Depreciation on such equipment differs from expenditures for labor, materials, etc., that become part of the cost of the facilities constructed

4. Depreciation must be deducted in the year it is properly deductible over the life of the depreciable property regardless of whether it contributes to the production of income in such year. See *Virginian Hotel Corporation* v. *Helvering*, 319 U.S. 523 (1943). Once depreciable property is devoted to a taxpayer's business, depreciation is an allowable deduction (and must be used to reduce the property's basis) regardless of whether or not the property is used to produce income in the taxable year or is idle and not used for any purpose. *Sears Oil Co., Inc.* v. *Commissioner*, 359 F.2d 191 (2nd Cir., 1966); *P. Dougherty Company* v. *Commissioner*, 159 F.2d 269 (4th Cir., 1946), certiorari denied, 331 U.S. 838 (1947); *Kittredge* v. *Commissioner*, 88 F.2d 632 (2nd Cir., 1937).

and need not be replaced until the end of the useful lives of these facilities. Their costs may properly be recovered by depreciation over the lives of such facilities.

The government urges that proper financial accounting requires that the deduction for depreciation be matched with the production of income citing such authorities as Paton, *Asset Accounting: An Intermediate Course,* 192-193 (1st ed., 1952), and Finney & Miller, *Principles of Accounting-Introductory,* 246-247 (6th ed., 1963), and argues that proper tax accounting in this situation accords with financial accounting (Pet. Br. 11-15).

However, the authors cited by the government, as well as numerous other writers on the principles of financial accounting, have pointed out that a simple allocation of depreciation based on historical cost over the useful life of equipment to match depreciation expense against income does not result in an accurate reflection of income for the reason that the owner must ordinarily replace the equipment at a higher cost. An additional expense is being incurred which is not reflected in the accounting statements. See and compare: Paton, *Asset Accounting: An Intermediate Course,* 313-314, 328-332 (1st ed., 1952); Finney & Miller, *Principles of Accounting—Intermediate,* 539-541 (6th ed., 1965); Simons, *Intermediate Accounting,* 527-529, 1016-1019 (5th ed., 1972); Meigs, Johnson, Keller and Mosich, *Intermediate Accounting,* 417-420 (2nd ed., 1968); Sprouse and Moonitz, *A Tentative Set of Broad Accounting Principles for Business Enterprises,* Accounting Research Study No. 3, 15-17, 32-34 (1962); Committee on Concepts and Standards—Long-Lived Assets, American Accounting Association, "Accounting for Land, Buildings and Equipment—Supplementary Statement No. 1", *The Accounting Review,* vol. XXXIX, No. 3, 693, 695-696 (1964). It has also been pointed out that different objec-

tives control the principles of tax accounting which as a consequence does not follow financial accounting. Finney & Miller, *Principles of Accounting—Introductory*, 562 (7th ed., 1970); Meigs, *supra*, 389, 638.

In its continuing attention to depreciation as a means of tax-free cost recovery Congress has recognized that in the taxation of income this presents a practical rather than a theoretical problem. If not resolved business will not be able to retain funds after tax to replace its capital equipment with efficient equipment and acquire additional equipment required for economic growth.

The problem of providing after-tax funds for replacement and improvement of capital facilities has two aspects. The first is that the historical cost of the equipment should be recovered without being subjected to tax. The second is that recovery of historical cost alone is not sufficient. If American business is to maintain its efficiency and to compete with business throughout the world, it must ordinarily replace equipment with improved and higher cost equipment and modernize and expand its capital facilities.

There are various possibilities for resolving the problems of replacing equipment at higher cost including allowing depreciation based on current cost or replacement cost coupled with various indices and other factors. See and compare: Paton, *Asset Accounting: An Intermediate Course*, 333-357 (1st ed., 1952); Simons, *Intermediate Accounting*, 1016-1053 (5th ed., 1972); Meigs, Johnson, Keller and Mosich, *Intermediate Accounting*, 420-424 (2nd ed., 1968).

However, Congress has not adopted these approaches suggested by accountants, but has instead adopted the principle of permitting recovery of historical cost through deductions for depreciation in the early portion of the equipment's useful life so that the funds retained after tax

together with earnings on such funds generated by their use in the taxpayer's business or by investment will permit the replacement of equipment at higher cost. Adoption of this concept is evident from the provisions of the Internal Revenue Code concerning the timing of the deduction for depreciation and explanatory reports of Congressional committees.

In section 167 of the Internal Revenue Code of 1954, Congress enacted specific provisions for the timing of depreciation deductions and allowed the use of the declining balance method at twice straight line depreciation rates and the sum of the years-digits method for computing depreciation. These methods permit the tax-free recovery of cost in the early portion of the life of equipment so that the taxpayer may, through use of the funds recovered in his own business, replace the equipment at a higher cost or acquire other modern facilities. For example, the declining balance method at twice straight line rates permits the deduction of approximately 40 percent of the cost of an asset in the first quarter of its useful life and two-thirds of the cost in the first half of its life. H. Rep. No. 1337, 83d Cong., 2d Sess., 23. The purpose of Congress was explained in the Report of the Committee on Ways and Means which contains the following statement:

> "There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installation of modern, up-to-date machinery. Under long-run peacetime conditions, in the absence of the inflationary pressures existing in the forced-draft economy of the postwar period, present tax depreciation methods might depress business capital expenditures below the level needed to keep the

economy operating at high levels of output and employment."

• • •

"More liberal depreciation allowances are anticipated to have far reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living."[5] (H. Rep. No. 1337, 83d Cong., 2d Sess., 22-24.)

Subsequently, in 1971 Congress amended the Internal Revenue Code to implement further its intention to utilize accelerated nontaxable cost recovery as a means of pro-

5. The importance of the rapid tax-free recovery of costs as a means of enabling United States industry to compete on the international level was recognized in the following statement:

"Various forms of faster write-off of fixed assets have been almost universally adopted in recent years by countries with modern income tax systems. Among such countries are Great Britain, Canada, and Sweden. The results of the liberalized depreciation policies have generally been favorable in stimulating plant modernization and expansion. While comparisons are difficult, the proposals contained in your committee's bill do not go as far in the direction of accelerated depreciation as the treatment in some other countries nor as far as some of the proposals which have been brought to your committee's attention. Mindful of the need for constructive action within the limits of sound budgetary policy, your committee has adopted provisions which will give the economy added stimulus and resilience without departing from realistic standards of depreciation accounting." (H. Rep. No. 1377, 83d Cong., 2d Sess., 24.)

viding funds for the replacement and improvement of equipment at higher cost. This is reflected in the enactment of section 167(m) of the Code pursuant to which Congress anticipated that lives for assets would be established by the Department of the Treasury on the basis of lives previously recognized in Guidelines for Depreciation, Revenue Procedure 62-21, 1962-2 C.B. 418. These lives were generally equal to the lives being claimed by taxpayers at the 30th percentile, i.e., 29 percent of the assets had shorter lives and 70 percent had longer lives. H. Rep. No. 92-533, 92d Cong., 1st Sess., 30; S. Rep. No. 92-437, 92d Cong., 1st Sess., 46. Further, in section 167(m) it was provided that taxpayers are permitted to use lives of up to 20 percent less than the lives so established.

The result of these provisions of the Internal Revenue Code concerning the timing of depreciation is that taxpayers are permitted to apply the double declining balance and sum of the years-digits methods of depreciation to useful lives reflecting the 30th percentile of actual lives previously used further reduced by 20 percent. Congress has effectively applied its concept of depreciation as a means of providing a tax-free recovery of cost so that taxpayers can replace equipment when no longer useful in their businesses, often at high costs, with modern equipment.

Therefore, Congress in implementing its historical concept of depreciation as a means of tax-free recovery of cost has not followed the concept of financial accounting that the deduction for depreciation should match the generation of income as urged by the government in this case. To carry out the intention of Congress, tax accounting reflects the deduction of depreciation in the early portion of the asset's life to provide for the tax-free recovery of cost so that equipment may be replaced at the end of its useful life

with efficient and more costly equipment and funds will be available for modernization. The correlation of the deduction of depreciation with the production of income is not an accounting principle which justifies the capitalization of depreciation on equipment used by the taxpayer to construct its facilities.

This Court has recognized that a departure from the financial accounting concept of matching expenses with income is appropriate in determining taxable income where required by statute or to carry out the intention of Congress. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Association* v. *United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957). Under the tax law expenses also may be deducted prior to the year in which the related income is realized. *Breeze Corporations, Inc.* v. *United States*, 117 F. Supp. 404 (Ct. Cl., 1954); *Patchen* v. *Commissioner*, 27 T.C. 592 (1956), A. 1957-2 C.B. 6, affirmed and reversed on other issues, 258 F.2d 544 (5th Cir., 1958); *Globe Corporation* v. *Commissioner*, 20 T.C. 299 (1953), A. 1953-2 C.B. 4; *Foster Wheeler Corporation* v. *Commissioner*, 20 T.C. 15 (1953), A. 1953-2 C.B. 4.

The government, applying the concept that depreciation, as distinguished from other types of deduction, must be matched against income, argues that the taxpayer should not be permitted to deduct depreciation over the 10 year life of its equipment, but instead should capitalize such depreciation and thereby spread it over a more than 40 year period which includes both the lives of the equipment and the self-constructed facilities. Such an argument is in direct conflict with the long recognized concept of Congress that depreciation is a method of tax-free recovery of capital investment which has been adopted to provide accelerated recovery in order to make available funds for higher cost replacement and for modernization.

Equipment used in self-construction by taxpayer represents a capital investment which like all other capital investments must be recouped if the equipment is to be replaced at the end of its useful life. It differs from expenditures such as direct labor and materials which need not be recovered until the constructed facilities must be replaced. It is as important to the economy and to the taxpayer that it be permitted to replace construction equipment with other equipment which is more efficient and costly at the termination of its life as it is to accumulate funds for the replacement of any other capital asset. The deduction for depreciation on taxpayer's equipment should not be disallowed under a financial accounting concept which is at variance with the Congressional purpose of cost recovery.

B. Financial concepts of cost do not accord with the provisions of the Internal Revenue Code.

The government urges that depreciation on equipment used by the taxpayer to self-construct facilities is part of the financial or economic cost of such facilities and should therefore be capitalized (Pet. Br. 10-11).

The term "cost" is nowhere defined in the Internal Revenue Code or even in the Treasury Regulations. At section 1012 of the Code it is provided that "[t]he basis of property shall be the cost of such property"; in the Treasury Regulations at 26 C.F.R. 1.263(a)-1 it is provided that "no deduction shall be allowed for—(1) [a]ny amount paid out for new buildings or for permanent improvements or betterments . . ." and 26 C.F.R. 1.263(a)-2(a) includes as an example of capital expenditures "[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment. . . ."[6] Read in their entirety, the Regu-

6. It is not stated or implied in the example that cost includes depreciation on equipment used by a taxpayer in self-construction.

lations interpreting section 263 of the Code necessarily imply that the cost of self-contructed facilities is the amount that must be capitalized under section 263. If section 263 does not require the capitalization of depreciation on equipment used in the self-construction of capital assets, the regulations do not convert such depreciation into a cost.

However, the government asserts that, on the basis of accounting and economic principles, depreciation on equipment used by the taxpayer to construct its facilities is part of the cost of such facilities and since it is cost it must be capitalized (Pet. Br. 10-11). This approach would resolve the question at issue without proper consideration of the applicable provisions of the Internal Revenue Code concerning depreciation and capitalization. It assumes the conclusion and reasons backwards.[7]

The problem is not one of general concepts of cost. For example, one possible definition of the cost of self-constructed property would be that there should be included in cost all amounts that contribute to the value of the property. In substance this would include all amounts that must

7. This same fundamental error was made by the Tax Court in this case and in varying degrees in the cases cited by the government as requiring capitalization of depreciation (Pet. Br. 22): *Coors* v. *Commissioner*, 60 T.C. 368 (1973); *Southern Natural Gas Co.* v. *United States*, 412 F.2d 1222 (Ct. Cl., 1969); *Producers Chemical Co.* v. *Commissioner*, 50 T.C. 940 (1968), A. 1969-1 C.B. 21; *Brooks* v. *Commissioner*, 50 T.C. 927 (1968), reversed on other grounds, 424 F.2d 116 (5th Cir., 1970); *Missouri Pacific R. Co.* v. *Commissioner*, 22 B.T.A. 267 (1931), A. and NA., X-2 C.B. 48, 95 (1930); *Gulf, M. & N.R. Co.* v. *Commissioner*, 22 B.T.A. 233 (1931), NA., XI-2 C.B. 13 (1932), affirmed on other issues, 71 F.2d 953 (D.C. Cir., 1934), affirmed on other issues, 293 U.S. 295 (1934); *Chicago, R.I. & P. Ry. Co.* v. *Commissioner*, 13 B.T.A. 988 (1928), reversed as to other issues, 47 F.2d 990 (7th Cir., 1931), certiorari denied, 284 U.S. 618 (1931); *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225 (1927), A. and NA., VII-2 C.B. 16, 47 (1928), affirmed, 40 F.2d 372 (8th Cir., 1930), certiorari denied, 282 U.S. 855 (1930).

be recovered by a third party if he had constructed the property. It would include among other elements, direct labor and materials, interest expense, state and local taxes, federal income tax and profit. However, as more fully discussed below, interest expense and state and local taxes have never been treated under the Internal Revenue Code as part of the cost of a self-constructed facility and the elements of federal income tax and profit would not be incurred or realized by a taxpayer constructing its own facilities.

A possible alternative would be to define cost as including all of those amounts which the taxpayer who constructed his own facilities would not have incurred but for such construction. Again this would include direct labor, materials, interest expense and state and local taxes even though the last two items have never been included in the cost of self-constructed facilities.

The provisions of the Internal Revenue Code rather than economic or accounting concepts are controlling for the purpose of ascertaining the basis of self-constructed facilities for federal income tax purposes. In the instant case the government has recognized this by not disallowing taxpayer's deductions for pension contributions, social security taxes and motor vehicle taxes attributable to the construction activities. The government concedes the correctness of these deductions (Stip. ¶14, App. 19) notwithstanding the fact that under economic or financial accounting standards these items would be part of the cost of self-constructed facilities.[8]

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8. Social security taxes and motor vehicle taxes were allowed as a deduction under Internal Revenue Code section 164. Pension contributions were allowed as a deduction under a long standing interpretation of the predecessor of section 404 in I.T. 3408, 1940-2 C.B. 178.

Even though Internal Revenue Code section 263, or a statutory predecessor, has been included in the applicable tax law since the beginning of present federal income tax laws in 1913, interest and state and local taxes, which would not have been incurred by a taxpayer but for his construction activities, have always been deductible by a taxpayer under sections 163 and 164 of the Internal Revenue Code and their statutory predecessors. Prior to the adoption of the statutory predecessor of section 266 of the Internal Revenue Code in section 130(a) of the Revenue Act of 1942,[9] no election could be made to capitalize these expenditures, *Southern Ry. Co.* v. *Commissioner*, 27 B.T.A. 673, 682-684 (1933), A. and NA., XII-2 C.B. 13, 25 (1933), affirmed and reversed on other issues, 74 F.2d 887 (4th Cir., 1935); *Spring Valley Water Co.* v. *Commissioner*, 5 B.T.A. 660, 662-663 (1926); and since that time they can be capitalized only if an election to do so has been made. *Stout* v. *Commissioner*, 31 T.C. 1199, 1211-1214 (1959), A. 1959-2 C.B. 7, affirmed and modified on other issues *sub nom.*, *Rogers* v. *Commissioner*, 281 F.2d 233 (4th Cir., 1960); *Kentucky Utilities Company* v. *Glenn*, 394 F.2d 631, 635 (6th Cir., 1968); *Smyth* v. *Sullivan*, 227 F.2d 12, 13-14 (9th Cir., 1955); Revenue Ruling 70-539, 1970-2 C.B. 70, 71.

This interpretation was analogous to the interpretation that prevented the capitalization of interest, taxes and carrying charges on unimproved and unproductive real property prior to the time when such capitalization was permitted by section 113(b)(1)(A) of the Revenue Act of 1932.[10] *Queensboro Corporation* v. *Commissioner*, 134

9. Revenue Act of 1942, ch. 619, 56 Stat. 798, 827.

10. Revenue Act of 1932, ch. 209, 47 Stat. 169, 201, subsequently superseded by sections 130(a) and 130(b) of the Revenue Act of 1942, ch. 619, 56 Stat. 798, 827.

F.2d 942, 944 (2nd Cir., 1943); *H.M.O. Lumber Co.* v. *United States*, 59 F.2d 907, 908-909 (6th Cir., 1932); *Central Real Estate Co.* v. *Commissioner*, 47 F.2d 1036, 1038 (5th Cir., 1931); *Westerfield* v. *Rafferty*, 4 F.2d 590, 593-594 (E.D.N.Y., 1925); *Appeal of Pacific Coast Redwood Co.*, 5 B.T.A. 423, 427 (1926), A. VI-2 C.B. 5 (1927).

The specific provisions of the Internal Revenue Code determine whether or not amounts must be capitalized, regardless of whether a taxpayer is required by a regulatory agency to capitalize such amounts on its books of account. Specifically, it has long been recognized that interest during construction, which was capitalized on a taxpayer's books of account in accordance with regulatory requirements, was nevertheless deductible for tax purposes and could not be added to the basis of constructed assets prior to the enactment of the statutory predecessors of section 266. *Southern Ry. Co.* v. *Commissioner*, 27 B.T.A. 673, 682-684 (1933), A. and NA., XII-2 C.B. 13, 25 (1933), affirmed and reversed on other issues, 74 F.2d 887 (4th Cir., 1935); *Spring Valley Water Co.* v. *Commissioner*, 5 B.T.A. 660, 662-663 (1926). The accounting requirements of regulatory agencies are not controlling for tax purposes. *Old Colony Railway Company* v. *Commissioner*, 284 U.S. 552, 562 (1931); *Mine Hill & Schuylkill Haven Railroad Company* v. *Smith*, 184 F.2d 422, 426 (3rd Cir., 1950), certiorari denied, 340 U.S. 932 (1951). The Internal Revenue Service has also recognized that interest during construction may be currently deducted notwithstanding the fact that the taxpayer is required to capitalize such interest on its books of account. Revenue Ruling 70-88, 1970-1 C.B. 32.

The fact that throughout the history of the federal income tax law, it has been interpreted to permit deductions of certain types of expenditures incurred by a tax-

payer in constructing its own facilities regardless of the existence of the statutory predecessors of section 263 necessarily indicates that the question of whether depreciation on equipment used in such construction must be capitalized may not be resolved by financial accounting concepts but instead turns on the intention of Congress as manifested in the provisions of the statute. The concepts adopted by Congress in enacting federal income tax laws are those appropriate for taxation and do not necessarily follow economic or financial principles. *Helvering* v. *Midland Mutual Life Insurance Co.*, 300 U.S. 216, 225 (1937); *Weiss* v. *Wiener*, 279 U.S. 333, 335 (1929).

This principle, that the provisions of the Internal Revenue Code are controlling, has been accepted by the government in the discussion in its brief of the decision in *All-Steel Equipment Inc.* v. *Commissioner*, 54 T.C. 1749 (1970), reversed in part, 467 F.2d 1184 (7th Cir., 1972) (Pet. Br. 17-18). However, the government is in error in its interpretation of the application of the principle to section 161.[11] The case concerned the question of whether deductions for taxes, losses and research and experimental expenditures could be deducted under sections 164, 165 and 174 of the Internal Revenue Code or must be included in inventory which is in effect a form of capitalization. The Tax Court held that these items were properly deductible. The government agrees with the conclusion of the Tax Court but disagrees with its analysis, urging that under section 161 of the Internal Revenue Code, deductions allowed by sections 162 through 188 are subordinate to sections 261 through 279 (Pet. Br. 18). However, section 161 does not make the

11. The government is also incorrect in its interpretation of the decision of the Court of Appeals in the present case. The basic decision of that court was that depreciation on property used in business is deductible under section 167 and section 263 does not disallow such deduction by requiring the capitalization of any "amount paid". (477 F.2d at 693-695; Pet. App. 30-32)

former group of sections subordinate to the latter in the sense implied by the government. Section 161 is a housekeeping section that merely makes the former group of sections "subject to the exceptions" of the latter group. Section 161 neither reduced the scope of the deductions in the former group nor increased the exceptions in the latter. For example the government agreed that the Tax Court was correct in *All-Steel Equipment* in not requiring the capitalization of a loss deductible under section 165 although the government could find no provision in sections 261 through 279 that specifically excepted losses from capitalization. The reason is that Congress did not intend that losses should be capitalized and included no language in section 263 or any other section that would require capitalization.

Just so in the instant case, section 167 allows a deduction for depreciation and there is no language in section 263 or any other section that requires capitalization. This issue must be resolved by application of the provisions of the Internal Revenue Code.

C. Sections 167 and 263 of the Internal Revenue Code are exclusively applicable.

The statutory provisions of the Internal Revenue Code control in determining whether depreciation on equipment used in self-construction may be deducted. *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 682 (1962); *Lewyt* v. *Commissioner*, 349 U.S. 237, 240 (1955); *Commissioner* v. *Korell*, 339 U.S. 619, 625-626 (1950).

Section 161 of the Internal Revenue Code provides that the deductions for individuals and corporations set forth at sections 162 through 188 shall be allowed "subject to the exceptions" provided in sections 261 through 279. Section 167 provides without limitation for a deduction for depre-

ciation on property used by a taxpayer in his trade or business. Section 263 concerning capitalization would limit the deduction for depreciation under section 167 only if it were intended by Congress to be an exception to such deduction. These two sections which are specifically applicable in determining whether depreciation on equipment used in self-construction is deductible prevail over all general provisions of the Code including the provisions concerning methods of accounting. *Spring City Foundry Company* v. *Commissioner*, 292 U.S. 182, 189 (1934); *Central Commercial Company* v. *Commissioner*, 337 F.2d 387, 389 (7th Cir., 1964); *Essenfeld* v. *Commissioner*, 311 F.2d 208, 209-210 (2nd Cir., 1963); *Service Life Insurance Company* v. *United States*, 293 F.2d 72, 77 (8th Cir., 1961).

II.

Section 167 allows the deduction of depreciation on equipment used in part by the taxpayer to construct its facilities.

For at least 40 years taxpayer has regularly engaged in the construction of additions to its own business properties, such as facilities for the transmission and distribution of electric energy. This construction has been substantial. The cost of facilities constructed by taxpayer amounted to more than $12,000,000 in 1962 and 1963, the years at issue.

Passenger cars, various types of trucks and power operated trailers were used in part for this construction and in part for operations and maintenance. Communication equipment was affixed to some items of this equipment. It is the portion of depreciation on this equipment which is attributable to construction activities which is at issue in the instant case.

Section 167 provides for a depreciation deduction with respect to property "used in the [taxpayer's] trade or business" or "held for the production of income [by the taxpayer]". The government has not asserted that the equipment was not used in taxpayer's trade or business to the extent it was used for operations and maintenance. However, in the Tax Court and the Court of Appeals the government argued that the equipment, to the extent it was used in constructing facilities, was not used in taxpayer's trade or business. While the Tax Court reached no decision on this issue, the Court of Appeals expressly found that the equipment was used in taxpayer's trade or business. In this Court the government apparently has abandoned this argument and concedes that the equipment, even when used in construction activities, is used in the taxpayer's trade or business (Pet. Br. 9). There is no longer any issue as to whether depreciation is allowable under section 167 and the only remaining issue is whether section 263 requires capitalization of this depreciation.

The government is correct in conceding that the equipment used to construct taxpayer's facilities was used in taxpayer's trade or business. The taxpayer was engaged in trade or business at the time the facilities were constructed. For more than 40 years taxpayer has constructed facilities while the taxpayer was at all times engaged in the transmission, generation and distribution of electric energy.

The courts have held that a taxpayer's trade or business includes all activities in furtherance of, or incidental to, the taxpayer's principal business. There is no requirement that a particular portion of a taxpayer's business activities be carried on to earn a profit or income separable from that derived from its principal business. For example, in *Corn Products Refining Company* v. *Commissioner*, 350 U.S. 46 (1955), the taxpayer, a manufacturer of products from

grain corn, purchased and sold corn futures to protect itself against price increases in corn and to assure itself of a supply of corn. It was held that gain and loss on the sale of corn futures was ordinary rather than capital as occurring in the ordinary course of the taxpayer's business.

The same principle has been applied in a variety of situations. Where taxpayer purchased stock in order to acquire an inventory or supply of materials for his business, a loss on the stock is realized in the ordinary course of his trade or business and treated as ordinary rather than capital. *Grier Co.* v. *United States,* 328 F.2d 163 (7th Cir., 1964); *Edwards* v. *Hogg,* 214 F.2d 640 (5th Cir., 1954); *The Journal Company* v. *United States,* 195 F. Supp. 434 (E.D. Wisc., 1961); *Smith and Welton Incorporated* v. *United States,* 164 F. Supp. 605 (E.D. Va., 1958). It has been decided that player contracts held by a corporation operating a professional baseball team are held primarily for sale to customers in the ordinary course of the taxpayer's business so that a gain or loss on the sale of such contracts is ordinary. *Hollywood Baseball Association* v. *Commissioner,* 423 F.2d 494 (9th Cir., 1970), certiorari denied, 400 U.S. 848 (1970). Real estate parcels acquired by an insurance company by mortgage foreclosures and thereafter rented for an extended period of time were held in the taxpayer's trade or business so that losses on sales of the property were ordinary. *Workmen's Mutual Fire Insurance Society, Inc.* v. *A'Hearn,* 286 F.2d 718 (2nd Cir., 1961).

Treasury Regulations applicable to the investment credit provide that where a taxpayer uses his equipment for self-construction of facilities, the equipment is depreciable. The investment credit is allowed at section 38 of the Internal Revenue Code for property qualifying at section 48. Under the latter section the investment credit is limited to property "with respect to which depreciation (or amortization

in lieu of depreciation) is allowable". The Regulations provide that the investment credit is allowed on the equipment used in self-construction, 26 C.F.R. 1.46-3(c)(1) and 1.48-1(b)(4), thereby treating such property as being used in the taxpayer's trade or business.[12]

The acquiring of facilities is part of taxpayer's trade or business of production, transmission and sale of electric energy. The scope of such trade or business includes the acquisition of facilities not only by purchase but also by self-construction.

III.

Congress did not intend that section 263 should require capitalization of depreciation on equipment used by a taxpayer in part to construct its facilities.

As a guide to the interpretation of the intention of Congress the government has stated that section 161 of the Internal Revenue Code indicates that section 263, applicable to capitalization, is controlling over section 167 which allows the deduction of depreciation (Pet. Br. 17-18). Section 161 of the Internal Revenue Code in substance provides that the deductions allowed at sections 162 through 188 are to be allowed "subject to the exceptions provided" in sections 261 through 279.

Section 161 was made part of the Internal Revenue Code in 1954 and the committee reports indicate that it is merely

12. The Treasury Regulations further provide that the depreciation allowable on equipment used in self-construction of facilities, although it must be capitalized, may not be included in the basis of the facilities constructed in computing the investment credit. 26 C.F.R. 1.46-3(c)(1) and 1.48-1(b)(4). The investment credit is allowed on the equipment and not on the facilities constructed which would be the result reached if depreciation on the equipment used in construction were not required to be capitalized.

a housekeeping section. In both the reports of the Committee on Ways and Means and the Committee on Finance, it is provided that this section "states the general rule that in computing taxable income there shall be allowed the deductions specifically provided in the other sections of part VI relating to itemized deductions" and no mention is made of the exceptions in sections 261 through 279. H. Rep. No. 1337, 83d Cong., 2d Sess., A43; S. Rep. No. 1622, 83d Cong., 2d Sess., 195. The intention of Congress in adopting section 161 was neither to limit its intention concerning the scope of the deductions in sections 162 through 188 nor to expand its intention concerning the scope of the exceptions provided in sections 261 through 279. With respect to the issue in the instant case it is a question of whether Congress intended that the deduction for depreciation allowed at section 167 was to be limited by an exception set forth in section 263.

Section 263 has never been interpreted as superseding the deductions allowed under sections 162 through 188 so as to require the capitalization of such deductions in the absence of an indication in the legislative history of the Internal Revenue laws that section 263 so required. For example, as pointed out in this brief at pages 19-20, *supra*, section 263 has never been interpreted as requiring the capitalization of interest deductible under section 164, even though such interest was paid during construction and would not have been paid but for the existence of such construction. Such amounts could not be capitalized until the adoption of the statutory predecessors of section 266 and may be capitalized only if an election is made. Loss deductions under section 165 have never been treated as amounts to be capitalized. As pointed out in the government's brief, the Treasury Regulations have long provided that losses are not to be included in inventory, 26 C.F.R.

1.61-3(a) (Pet. Br. 18), and no effort has been made by the Treasury Department to require capitalization of losses as part of the adjusted basis of the facilities constructed regardless of the existence of section 263.

With respect to the question at issue, section 263 requiring capitalization does not provide for an exception to section 167 which allows the deduction for depreciation for the reason that Congress has not intended that there shall be an exception. As will be more fully discussed, section 263 which applies only to "amount[s] paid out" or "expenditures" was not intended by Congress to be an exception to the deduction for depreciation allowed by section 167.[13]

13. The government appears to assert as independent grounds for decision that the Internal Revenue Service has consistently treated depreciation on equipment used in self-construction of facilities as being the equivalent of cost or basis, and that courts with a special responsibility for interpreting federal tax laws have held that such depreciation should be capitalized.

The government has not consistently treated depreciation used in self-construction of facilities as being the equivalent of cost or basis. The statutory predecessors of sections 167 and 263 have been part of the income tax law since 1913. During the period 1927 through 1934 there was a series of court cases concerning the capitalization of depreciation in which it was held in the last case, *Great Northern Ry. Co.* v. *Commissioner*, 30 B.T.A. 691 (1934), that depreciation on construction equipment used in self-construction was not to be capitalized. Thereafter it was not until 1955 that the Internal Revenue Service first issued an opinion requiring capitalization, Revenue Ruling 55-252, 1955-1 C.B. 319. In 1958, the Treasury Department issued regulations under Code section 263. The basic regulation disallows deduction for "[a]ny amount paid out for new buildings or permanent improvements. . .", 26 C.F.R. 1.263(a)-1, issued as T.D. 6313, 1958-2 C.B. 114, and one example of capital expenditures included "[t]he cost of acquisition, construction or erection of buildings, machinery . . .", 26 C.F.R. 1.263(a)-2(a). This example does not state or imply that depreciation on equipment used in self-construction shall be capitalized. It is reasonable to infer that cost as used in the example refers merely to that which must be capitalized under section 263 of the Internal Revenue Code which does not include depreciation on equipment used in the self-construction of assets.

Further the Regulations have not been consistent. Under sections 46(a), 46(c) and 48(b) of the Internal Revenue Code the

As a second guide to the interpretation of the Internal Revenue Code, the government asserts that section 263 must be read expansively as the legislative expression of the principle of capitalization (Pet. Br. 21) and reliance is placed on *Commissioner* v. *Lincoln Savings and Loan Association*, 403 U.S. 345 (1971). The decision in this case does not sustain the government's assertion for it merely held that payments of additional premiums by the taxpayer savings and loan association to the Federal Savings and Loan Insurance Corporation were not deductible as ordinary and necessary expenses incurred for the carrying on of

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investment credit is allowed on the "basis" of property constructed. However, 26 C.F.R. 1.46-3(c)(1), 1.48-1(b)(4) and Revenue Ruling 69-228, 1969-1 C.B. 29, provide that the basis of self-constructed facilities shall not include depreciation on equipment used in construction for investment credit purposes.

With respect to the decisions by courts having special responsibility of interpreting and applying the tax laws, such decisions are neither uniform nor have they given proper consideration to the problem of analysis of the applicable provisions of the Internal Revenue Code. Many of these decisions made the fundamental error of accepting the proposition that anything which might appear to be part of the cost of the facilities constructed should be capitalized regardless of the provisions of the Internal Revenue Code. The first group of cases decided by the Board of Tax Appeals, and in one case affirmed, reached the conclusion that depreciation on equipment used in self-construction of facilities should be capitalized without adequate consideration. These cases include: *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225 (1927), A. and NA., VII-2 C.B. 16, 47 (1928), affirmed, 40 F.2d 372 (8th Cir., 1930), certiorari denied, 282 U.S. 855 (1930); *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 13 B.T.A. 988 (1928), reversed as to other issues, 47 F.2d 990 (7th Cir., 1931), certiorari denied, 284 U.S. 618 (1931); *Gulf, M. & N. R. Co.* v. *Commissioner*, 22 B.T.A. 233 (1931), NA. XI-2 C.B. 13 (1932), affirmed on other issues, 71 F.2d 953 (D.C. Cir., 1934), affirmed on other issues, 293 U.S. 295 (1934); *Missouri Pacific R. Co.* v. *Commissioner*, 22 B.T.A. 267 (1931), A. and NA. X-2 C.B. 48, 95 (1931). Thereafter the Board of Tax Appeals reversed its position and held that the depreciation on equipment used in self-construction should not be capitalized. *Great Northern Ry. Co.* v. *Commissioner*, 30 B.T.A. 691 (1934). Subsequently, the Tax Court of the United States decided *Brooks* v. *Commissioner*, 50 T.C. 927 (1968), reversed on other grounds, 424 F.2d 116 (5th Cir., 1970), and *Producers Chemical Co.* v. *Commissioner*, 50 T.C. 940

the taxpayer's trade or business under section 162(a). It was pointed out by this Court that the language used in section 162(a) and section 263 was not all inclusive (403 U.S. at 359). However, this is not to suggest that section 263 is a supervening provision of the Internal Revenue Code which is to be applied more expansively than was intended by Congress in adopting and amending it. It is well established that the provisions of the Internal Revenue Code should be interpreted to carry out the intention of Congress as indicated by the legislative history of such provisions. *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962); *Commissioner* v. *Korell*, 339 U.S. 619 (1950); *Helvering* v. *Hammel*, 311 U.S. 504 (1941).

The issue in the present case differs from *Lincoln Savings and Loan* in that here the government asks this Court

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(1968), A. 1969-1 C.B. 21, in which depreciation was held to be one of the costs involved in rendering the service of producing oil which the taxpayer was required to produce without charge in partial payment for oil leases. Thereafter, the Tax Court decided *Coors* v. *Commissioner*, 60 T.C. 368 (1973), again without proper consideration of the applicable sections of the Internal Revenue Code. The decision cited by the government in which the most analysis was given to the issue is *Southern Natural Gas Co.* v. *United States*, 412 F.2d 1222 (Ct. Cl., 1969). In this case neither party took exception to the decision of the Trial Commissioner and his opinion was in substance adopted by the Court of Claims. It is submitted that it involves various errors of analysis, including such errors as defining the issue as one of carving out an exception for the deduction for depreciation (412 F.2d at 1265) where the issue in fact is whether Congress intended section 263 to be an exception to the deduction for depreciation allowed at section 167 without limitation for property used in business. A second error was the assumption that if the deduction for depreciation were allowed, the taxpayer would have a double recovery of cost, first when the depreciation was deducted and second when the self-constructed facility was sold (412 F.2d at 1265). Such a conclusion is clearly incorrect for if depreciation were deducted it would not be included in the basis of the facility constructed. A third error was the Trial Commissioner's inference that self-constructed facilities would have no basis (412 F.2d at 1266). This inference is unwarranted for such facilities would have a basis equal to the amounts expended for labor, materials, supplies and all other amounts paid out or expenditures which under section 263 of the Internal Revenue Code must be capitalized.

to ignore the words "amount paid out" and "expenditures" in section 263 to apply this section to depreciation of property which is neither. As hereinafter set forth the legislative history of section 263 indicates that Congress did not intend these terms, as used in this section, to include depreciation and uniformly throughout the Internal Revenue Code where Congress has intended the word "expenditures" to include depreciation in particular sections it has expressly so provided in each of such sections. There is no provision of this type in section 263 for the reason that capitalization of depreciation is contrary to the Congressional intention that depreciation is a means whereby a taxpayer may recover the capital cost of property over its own life. Under these circumstances the terms "amount paid out" and "expenditures" should be interpreted in accordance with their ordinary meaning. *Malat* v. *Riddell*, 383 U.S. 569 (1966); *Crane* v. *Commissioner*, 331 U.S. 1 (1947).[14]

14. The government suggests Congress has often manifested its awareness that construction related depreciation is non-deductible and gave as an example a quotation from the Report of the Committee on Finance concerning section 263(a)(1)(E), which excepts from capitalization the allowable deduction under section 182 for farmers' land-clearing expenses (Pet. Br. 18-19). It is submitted that the quotation from the Senate Finance Committee has been so edited as to be misleading insofar as it is relevant in the instant case. The full statement by the Senate Finance Committee is as follows:

> "Subsection (d) (2) of section 182 provides that expenditures to which section 182(a) applies shall include a reasonable allowance for depreciation with respect to property which is used in the clearing of land for the purpose of making such land suitable for use in farming *and which if used in a trade or business, would be property subject to the allowance for depreciation.* Under present law such depreciation must be capitalized." (S. Rep. No. 1881, 87th Cong., 2d Sess., 338) [Emphasis supplied]

From this full statement it is apparent that the Senate Finance Committee's view of depreciation as being nondeductible was based on the concept that the property used in the clearing of land was not used in a trade or business. To the extent there can be any doubt about this, such doubt is resolved by the following statement which appeared earlier in the Senate Finance Committee Report:

A. The legislative history of section 263 indicates that depreciation is not intended by Congress to be treated as an amount paid out.

Section 263 provides as follows:

> "(a) GENERAL RULE.—No deduction shall be allowed for—
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—. . . ."

"This new provision deals with a problem quite similar to that which resulted in the enactment of the soil and water conservation provision. At the present time, expenditures made during the preparatory period in extending a farm may not be deducted since they are not expenses incurred in the business of farming." (S. Rep. No. 1881, 87th Cong., 2d Sess., 126)

From these statements it is clear that Congress felt that the depreciation was nondeductible because the property with respect to which the depreciation would be claimed was not used in a taxpayer's trade or business. As previously set forth, *supra*, pages 23-26, in the instant case the taxpayer's equipment, with respect to which depreciation is claimed, is used in its trade or business and the government has abandoned any argument with respect to this issue before this Court.

The government also cites the legislative history surrounding the enactment of section 263(a)(1)(B), excepting from capitalization the elective deduction allowed under section 174 for research and experimental expenditures, the predecessor of section 263(a)(1)(A), excepting from capitalization the elective deduction provided under section 616 for certain expenditures incurred in the development of mines, and sections 263(a)(1)(C) through (E) as suggesting a Congressional awareness that construction-related depreciation is not deductible. These exceptions are merely to conform section 263 with other provisions of the Code permitting an election to deduct, usually up to a maximum amount, or capitalize expenditures related to certain types of activities. The expenditures involved were of various types including labor, materials, etc. Where depreciation was involved in such other provisions of the Code, Congress found it necessary to define depreciation as an expenditure to include it in the sections providing elections. Congress has not found it necessary to provide an exception from section 263 for depreciation on equipment used in self-construction because the section does not by its terms and was not intended by Congress to require capitalization of depreciation. No occasion has been found when Congress considered such an unnecessary exception and in absence of consideration, it could not have been rejected by Congress. Compare Pet. Br. 19.

Thereafter there are listed various "expenditures" which are not to be capitalized equating the word "expenditures" with "amount[s] paid out".

The language still used by Congress to spell out the requirements for capitalization in the Internal Revenue Code was first used as part of an income tax statute in 1864. In a statute enacting a Civil War income tax, Act of 1864, ch. 173, 13 Stat. 223, Congress used language virtually identical to that in section 263 to deny deduction of certain amounts in computing income subject to tax. Section 117 of this Act provides as follows:

> ". . . but no deduction shall be made for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate. . . ." (13 Stat. 223, 282)

The Civil War statute did not allow a deduction for depreciation since depreciation had not yet been recognized for financial accounting or other purposes in the United States. *San Diego Land & Town Company* v. *Jasper*, 189 U.S. 439, 446 (1903); *Eyster* v. *Centennial Board of Finance*, 94 U.S. 500, 503 (1877); *cf. United Railways & Electric Company of Baltimore* v. *West*, 280 U.S. 234, 265 (1930) (dissenting opinion). Therefore, this language when first used was not intended by Congress to deny or limit a deduction for depreciation.

In 1909 when Congress first adopted a tax statute that could be considered a direct predecessor of the present Internal Revenue Code, the Tariff Act of 1909, ch. 6, 36 Stat. 11, it did not include a provision requiring capitalization, even though capitalization of the amounts expended to acquire capital assets was necessarily to be inferred, but it did include a provision which would indicate that its concept of depreciation was not that of an amount paid out which could be required to be capitalized. At

section 38, Second, there was allowed a deduction from gross income for ". . . all losses actually sustained within the year . . . including a reasonable allowance for depreciation of property, if any. . . ." 36 Stat. 11, 113. In equating depreciation with losses, Congress manifested an understanding of depreciation as being a deduction of a type that could not be capitalized. Up to the present time, there has been no effort on the part of the Treasury Department to capitalize losses as part of the cost of an asset, and without reliance on any particular provision of the Code, they are expressly excluded from cost under the Regulations concerning inventories. 26 C.F.R. 1.61-3(a).

When the Tariff Act of 1913, ch. 16, 38 Stat. 114, was adopted, Congress at section II B, with respect to individuals, provided that "no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate". 38 Stat. 114, 167. There was no similar requirement for capitalization in the case of corporations. Congress continued to manifest an understanding that depreciation was similar to a loss by combining these two deductions with respect to corporations at section II G(b) although they were separate with respect to individuals. 38 Stat. 114, 172.

In the Revenue Act of 1916, ch. 463, 39 Stat. 756, at section 12(a) Second, Congress first explicitly imposed the requirement for capitalization on corporations by providing "[t]hat no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments" and continued to manifest its understanding that depreciation and losses were to be equated by combining both deductions at section 12(a) Second, which allowed a deduction for "[a]ll losses actually sustained and charged off within the year . . . including a reasonable allowance for

the exhaustion, wear and tear of property." 39 Stat., 756, 768.

Thereafter in 1918 rearrangements were made of the locations of the deduction for depreciation and of the requirement for capitalization. Other than the addition of the word "expenditures" as being the equivalent of "amount[s] paid out" in the Revenue Act of 1951, section 309, ch. 521, 65 Stat. 452, 487, the language providing for capitalization has been continued without substantial change.

When Congress first adopted the requirement of capitalization in the statutory predecessors of section 263, it clearly intended that capitalization should be applicable only to amounts paid out and that depreciation was not in the nature of an amount paid out. Rather, depreciation was regarded as similar to a loss of property or a decrease in value of property. See and compare: *Fribourg Navigation Company, Inc.* v. *Commissioner*, 383 U.S. 272, 276 (1966); *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960); *United States* v. *Ludey*, 274 U.S. 295, 300 (1927).[15]

The same concept is expressed in the Regulations at 26 C.F.R. 1.167(a)-1 which provides in part:

15. For similar indications of the nature of depreciation outside of the field of taxation, see *Lindheimer* v. *Illinois Bell Telephone Company*, 292 U.S. 151, 167 (1934); *Knoxville* v. *Knoxville Water Company*, 212 U.S. 1, 13 (1909); *Colorado Interstate Gas Co.* v. *F.P.C.*, 142 F.2d 943, 959 (10th Cir., 1944), affirmed and reversed on other issues, 324 U.S. 581, 626 (1945).

A similar understanding was expressed in a report of a Subcommittee of the Committee on Ways and Means in 1933 in the following statement:

> "In the first place, it must be remembered that these amounts [depreciation and depletion] deducted from income do not represent cash outgo like wages, repairs, and similar expenses, but are annual reserves generally theoretically set aside to replace plant and property investments. . . ." (Report of Subcommittee of the Committee on Ways and Means, H. Rep. December 4, 1933, 73d Cong., 2d Sess., 4)

> ". . . The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amount set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and §1.167(g)-1. . . ."

The intention of Congress that section 263, which is applicable only to an amount paid out and does not provide an exception from the deduction for depreciation, as indicated by the early legislative history of sections 263 and 167, is consistent with the subsequent emphasis placed by Congress on the deduction for depreciation as a means of tax-free recovery of cost in its amendments at the time of the adoption of the Internal Revenue Code of 1954 and thereafter. As previously pointed out in this brief at pages 12-13, *supra*, Congress, recognizing the need for taxpayers to recoup the cost of their capital assets in order that they may be replaced at the end of their useful lives with efficient and probably higher cost assets and in order that taxpayers will have available funds to modernize equipment to meet competition from abroad, adopted accelerated methods of depreciation such as the declining balance method and the sum of the years-digits method. The declining balance method permits the deduction of approximately forty percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life. H. Rep. No. 1337, 83d Cong., 2d Sess., 23. As further pointed out in this brief at pages 13-14, *supra*, in 1971 the ability of taxpayers to recover their capital investment in the early portion of the lives of their assets was increased by legislation permitting the use of lives in the 30th percentile of the lives previously used by taxpayers and further allowing such lives to be reduced by 20 percent. The end result of

these provisions is to permit as large as a 50 percent deduction of the cost of equipment in the first partial year of its useful life.[16] This emphasis by Congress on allowing accelerated tax-free recovery of the capital cost of equipment to provide taxpayers with funds for replacement and modernization is incompatible with the intention the government attributes to Congress of requiring the capitalization of depreciation on equipment used by the taxpayer in self-construction and thereby deferring recovery of cost until long after the termination of the life of the asset.

It is apparent that in adopting these provisions Congress has continued its objective of treating depreciation as a means of tax-free recoupment of the cost of capital assets rather than as a means of matching the deduction for depreciation against the production of income as urged by the government (Pet. Br. 9). Such a theory of matching depreciation against income is the only possible justification for the deferral of depreciation urged by the govern-

16. In its administration of the deduction for depreciation the Department of the Treasury has increasingly recognized the Congressional intent to emphasize recovery of cost. On January 11, 1971, the Treasury Department issued a statement in which it described the Asset Depreciation Range System pursuant to which taxpayers were to be permitted to elect to compute depreciation. In an example set forth in this statement, there is discussed the depreciation to be allowed on lathes acquired on June 15, 1971 for $10,000 and a drill press acquired on October 1, 1971 for $5,000, the total cost being $15,000. The anticipated lives of these items of equipment are five years. Depreciation is to be taken on the double declining balance method. The depreciation to be allowed in the year 1971 is $6,250 computed in the following manner. Under the Asset Depreciation Range System, the taxpayer will be permitted to depreciate the property over a period of four years and to obtain a full year's depreciation on the lathes which were placed in service before July 1, 1971 and one-half year's depreciation on the drill press which was placed in service after that date. Applying the double declining balance method on a four year life, the taxpayer will be able to deduct $5,000 depreciation for the lathes and $1,250 for the drill press. (Treasury Statement of January 11, 1971 as reported in Standard Federal Tax Reports, Commerce Clearing House, 1971 Volume 7, ¶6366 at page 71,130)

ment in the instant case, a theory which has never been part of the income tax law. *Virginian Hotel Corporation* v. *Helvering*, 319 U.S. 523 (1943).

As previously pointed out in this brief, at pages 9 and 16, *supra*, equipment used by a taxpayer in the self-construction of its facilities represents a capital investment which like all other capital investments must be recouped if the equipment is to be replaced with modern equipment at the end of its useful life. The taxpayer has the same need to obtain more modern equipment for use in the construction of its own facilities as it has to replace and modernize like equipment used in maintenance or operations or as a contractor would have if he constructed the facilities for taxpayer. The investment for equipment used in self-constructed facilities differs from such expenditures as direct labor and materials, the cost of which need not be fully recovered until the constructed facilities must be replaced. The clear intention of Congress evidenced in the legislative history of section 263 that depreciation is not an amount paid out for which capitalization is required under this section is applicable to all depreciation including depreciation on equipment used by a taxpayer in the self-construction of facilities.

B. Where Congress has intended to treat depreciation as an amount paid or an expenditure it has uniformly so provided in the Internal Revenue Code indicating its understanding that in the absence of such a provision depreciation was not intended to be included in such terms.

Congress has in certain sections of the Internal Revenue Code provided that a taxpayer may elect to treat specific types of expenditures either as an expense, often subject to limitations, or as capital. These sections cover a broad scope of expenditures including labor, material and supplies and similar expenditures. However, where Congress has

in these sections intended that depreciation shall also be treated as an expenditure to be either deducted, ordinarily up to a maximum amount, or capitalized, Congress has expressly included a provision to this effect in the sections. Clearly Congress understood that it was necessary to provide that depreciation was an expenditure in order to treat it as such in these sections for it did not provide a special definition of the other items involved.

In other sections of the Internal Revenue Code Congress has permitted deduction of an amount paid or of which payment is made and has not expressly provided that depreciation is to be treated as an amount paid or an expenditure. In these sections depreciation is not treated as an expenditure.

Consistently throughout the Internal Revenue Code, wherever Congress has intended that depreciation should be treated as an expenditure it has expressly so provided. The sections of the Internal Revenue Code in which an election to treat expenditures as an expense or as an amount to be capitalized include the following. At section 174 a taxpayer may elect to treat research and development expenditures as expenses or to capitalize such expenditures as deferred expenses amortizable over a period of not less than 60 months. At section 182 a taxpayer engaged in the business of farming may elect to treat expenditures for clearing of land as an expense subject to limitation on the maximum amount and if no election is made or if the expenditures exceed the maximum they are to be capitalized. In section 615 a taxpayer may treat pre-1970 exploration expenditures as an expense subject to a maximum limitation, but if the expenditures exceed the maximum or if an election is made the expenditures are to be capitalized and amortized on a ratable basis as ores are produced. In section 616 a taxpayer is permitted to deduct mine development expenditures or to elect to capitalize such expenditures and deduct them on a ratable basis as ores are

produced. In section 617 a taxpayer is permitted to elect to deduct exploration expenditures to locate and ascertain the quality of deposits of ores or minerals subject to a maximum limitation but in the absence of such election or if the expenditures exceed the maximum amount, they are to be capitalized.

These sections were enacted to provide for elective treatment of expenditures in situations in which there had previously been doubt as to whether the expenditures were to be deducted or capitalized;[17] the expenditures may have been incurred prior to the time a taxpayer was considered to be engaged in a trade or business and therefore nondeductible;[18] or it was the position of the Internal Revenue Service that the expenditures should be capitalized.[19]

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17. For example in the case of research and experimental expenditures there was uncertainty in the law concerning deduction or capitalization. H. Rep. No. 1337, 83d Cong., 2d Sess., 28; S. Rep. No. 1635, 83d Cong., 2d Sess., 33.

18. As previously set forth at pages 31-32, *supra*, Congress stated that expenditures by farmers for clearing land could not be deducted because they were preparatory to farming and not incurred in the business of farming.

19. With respect to expenditures for discovery or exploration of minerals, after the enactment of section 23 (ff) of the Internal Revenue Code of 1939, in the Revenue Act of 1951, section 342, ch. 521, 65 Stat. 452, 515, which first provided the taxpayer with an option to deduct or capitalize exploration expenditures (in this case up to a maximum of $75,000), the Internal Revenue Service was of the view that depreciation on equipment used in exploration by a taxpayer engaged in the trade or business would be deductible in full in absence of a specific provision in section 23 (ff) treating depreciation as an expenditure. In Treasury Regulations 118 at section 39.23 (ff)-1(c) the following statement was made:

> "The deduction described in paragraph (a) of this section is allowable only for the amount of all such expenditures paid or incurred by the taxpayer in the taxable year as does not exceed $75,000. Amounts otherwise allowable as deductions without reference to this section (except allowances for depre-

In each of the sections of the Internal Revenue Code in which Congress provided an option to deduct or capitalize the expenditures, Congress found it necessary to provide specifically that depreciation would be treated as an expenditure to make it clear that it would be treated as such. For example, at section 615(a) it is provided:

> "This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures paid or incurred. . . ."

A statement to the same effect is made in each of the sections providing for an election.

However, in the case of section 263, Congress has never provided that depreciation shall be considered as an amount paid out or an expenditure. In light of the care Congress has taken throughout the Internal Revenue Code to define or designate depreciation as an expenditure when it is intended to be treated as such, it is apparent that Congress has continued the intention of previous Congresses which first enacted the statutory predecessors of section 263 that depreciation should not be considered as an amount paid out or an expenditure under this section.

On the other hand where Congress has not intended the terms "payment" or "amount . . . paid" to include depreciation, it has not included in the applicable section of the Internal Revenue Code a provision that defines depreciation as being within the scope of these terms. Two exam-

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ciation) are not to be taken into account in determining this limitation."

Compare *New Quincy Mining Company* v. *Commissioner*, 36 B.T.A. 376 (1937), in which it was held that depreciation incurred in development of a mine was not deductible where the taxpayer had not yet engaged in business.

ples appear at section 170(a)(1), where a deduction is allowed for ". . . any charitable contribution . . . payment of which is made within the taxable year . . .", and section 213(a) in which there is allowed a deduction for medical and dental expenses equal to ". . . the amount by which the amount of the expenses paid during the taxable year . . . exceeds 3 percent of the adjusted gross income . . . ."

It has been regularly held that automobile expenses incurred for charitable or medical purposes, such as those incurred for gas, oil and automobile taxes, would qualify for the charitable and medical expense deductions. However, in the decisions allowing such expenses as a deduction, it has been uniformly held that depreciation is not an amount, payment of which was made, which would qualify as a charitable contribution or an amount paid which would qualify as a medical or dental expense. *Orr* v. *United States*, 343 F.2d 553 (5th Cir., 1965); *Mitchell* v. *Commissioner*, 42 T.C. 953 (1964), A. 1965-2 C.B. 6; *Gordon* v. *Commissioner*, 37 T.C. 986 (1962); *Calafut* v. *Commissioner*, 23 T.C.M. 1431 (1964).[20] The reasoning of the courts was clearly that depreciation was not an amount paid. As the court stated in *Orr* v. *United States, supra:*

> "It is entirely possible, as the taxpayer suggests, that Congress and its Committees were not thinking of depreciation when they used the word 'payment'. The absence of any evidence as to whether Congress focused on this problem provides no basis for extend-

20. Under the Internal Revenue Code of 1939 the same conclusion has been reached, depreciation is not amount paid. At section 201(c)(7)(B) of the Internal Revenue Code of 1939 insurance companies were allowed a deduction for ". . . investment expenses paid during the taxable year". In *State Mutual Life Assurance Company of Worcester* v. *Commissioner*, 246 F.2d 319 (1st Cir., 1957), the court alternatively held that depreciation could not be deducted in any event as an investment expense under section 201(c)(7)(B) on the ground that depreciation is not an expense paid.

ing the meaning of payment to include 'depreciation'. A depreciation expense is an indispensable element in accounting. But it is not a 'payment', not a transfer of money or property. We are bound by plain, prosaic language of the statute. . . ." [Footnote omitted] (343 F.2d 553, 556)

In *Gordon* v. *Commissioner, supra,* the Tax Court made the following statement:

". . . The statute permits the deduction for 'expenses paid' and 'amounts paid' and respondent correctly interprets the statute as permitting deduction for 'medical expenses actually paid.' Sec. 1.213-1(a), Income Tax Regs. Depreciation is a 'decrease in value.' *Massey Motors Inc.* v. *United States,* 364 U.S. 92, 96. Any allowance for depreciation is not an 'expense paid' or 'amount paid.'" (37 T.C. 986, 987)

Sections 170 and 213 are applicable both to cash basis and accrual basis taxpayers. It is not a grounds for distinction that sections 170 and 213 could be considered as concerning only cash basis taxpayers.

It would appear that in adopting the language of both sections 170 and 213 Congress intended that the deduction for charitable contributions and medical expenses was to be limited to amounts paid for these purposes. In these sections Congress had no intention to extend the deductions to amounts which were not paid and therefore did not include in them a definition of paid or payment which would include depreciation. It is a further illustration in the Internal Revenue Code of the fact that when Congress intended depreciation to be considered an amount paid or the equivalent thereof it specifically so provided.

However, the government argues implicitly that although the terms "payment" or "amount . . . paid" may properly

include depreciation as an item paid when their equivalent is used in section 263, they do not include depreciation in section 170 or section 213 for the reason that section 170 requires payment "within the taxable year" and section 263 requires that the amount be paid "during the taxable year" (Pet. Br. 24). The government necessarily argues that the words "amount paid" in section 263 do include depreciation on the theory that payment is not expressly required under section 263 *in the taxable year*. The government suggests that for section 263 but not for sections 170 or 213 it is sufficient that the amount be paid at some time such as when the assets involved were purchased (Pet. Br. 23).[21]

The distinction urged by the government between sections 170, 213 and 263 does not exist. If depreciation is an amount paid under section 263 it must be paid during the taxable year. Clearly the depreciation the government urges must be capitalized under section 263 is the amount which must be considered paid during the taxable year in which equipment is used in self-construction in order to disallow the deduction under this section. It is only the depreciation on the equipment used in construction during the year in which it is so used that the government would capitalize. As a specific example, if one of taxpayer's trucks was used in part to construct facilities during the year 1962, it is the portion of the depreciation on that truck during the period it was used for construction in 1962 that the government would disallow and capitalize as part of the basis of the facility constructed. If the truck were used in part in construction of a single facility begun in 1962 and

21. This suggestion if applied to section 263 would equally indicate a "capricious" intention on the part of Congress as it would if applied to indicate that Congress intended a deduction for depreciation under sections 170 and 213 in the year an automobile was purchased (Pet. Br. 24, n 9). Under all three sections it is the depreciation for the taxable year which must come within the scope of "amount paid out" (section 263), "payment" (section 170) or "amount . . . paid" (section 213).

completed in 1963, for the year 1962 the government would disallow the depreciation and capitalize it as part of the basis of construction in progress and for the year 1963 the government would disallow depreciation on the truck and include it, as well as depreciation for the year 1962, in the basis of the completed facility. Depreciation must be considered an amount paid on an annual basis if it is to be treated as an amount paid under section 263 to the same extent that it would have to be considered an amount paid on an annual basis if it is to be deducted under sections 170 and 213.[22]

It is not the requirement for annual determinations that prevents depreciation from being treated as a payment under section 170 or an amount paid under section 213. Instead it is the fact that Congress does not intend by use of these terms in sections of the Code to include depreciation in the absence of a specific provision so indicating and Congress did not include provisions to this effect in sections 170 and 213.

The legislative history of section 167 allowing depreciation and section 263 concerning capitalization indicates that when Congress adopted these provisions it did not intend that section 263, which provides for the capitalization of amounts paid out, later extended to include expenditures as an equivalent term, should require the capitalization of depreciation. The intention of Congress to permit the deduction of depreciation without limitation is consis-

22. Had Congress intended to include depreciation within the meaning of payment in section 170 and amount paid in section 213, it could have defined these terms to include depreciation as it has in other sections of the Code. The sections could then be administered by requiring proof of the amount of the depreciation or by including it in the arbitrary allowance for automobile expenses under such sections. Revenue Procedure 70-24, 1970-2 C.B. 505, allows a deduction of six cents per mile for automobile expenses as charitable contributions and medical expenses which does not include any allowance for depreciation.

tent with the continued emphasis placed by Congress on permitting taxpayers to recover the capital costs of assets over their useful lives, and presently in the early portion of such lives, in order that taxpayers will have funds to replace the assets ordinarily with more costly modern equipment. The understanding of Congress that an amount paid or an expenditure, as used in section 263, does not include depreciation is further indicated by the care taken by Congress throughout the Internal Revenue Code to define those terms as including depreciation in any section in which it intended to treat depreciation as such and not to include such a definition in any section where it was not so intended. In section 263, Congress has not defined amount paid or expenditure as including depreciation thereby indicating its continued intention that this section should not limit, or provide an exception to, the deduction for depreciation.

It is not to be inferred that this is a matter of inadvertence. It is equally important for a taxpayer who uses equipment in self-construction to be permitted tax-free recovery of the cost of such equipment over its life in order that it may be replaced and modernized as it is for taxpayers who recover cost by depreciation on equipment used for other purposes.

In light of the intention of Congress that amount paid and expenditures in section 263 should not include depreciation which is a reduction in value of property as it is used, these terms should be interpreted in accordance with their ordinary meaning. *Malat* v. *Riddell*, 383 U.S. 569 (1966); *Crane* v. *Commissioner*, 331 U.S. 1 (1947). Section 263 should be construed to carry out the intention of Congress that it is not an exception to or a limitation on the deduction for depreciation allowed in section 167. *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962); *Commissioner* v. *Korell*, 339 U.S. 619 (1950); *Helvering* v. *Hammel*, 311 U.S. 504 (1941).

The government's assertion that depreciation on equipment used in self-construction should be capitalized in order to match the deduction for depreciation against generation of income in accordance with financial accounting principles is contrary to the tax accounting required by the principles of depreciation adopted by Congress in allowing the tax-free recovery of the cost of a capital asset over the early portion of its life. Matching of the deduction for depreciation against income has never been a requirement or principle of tax law, *Virginian Hotel Corporation* v. *Helvering*, 319 U.S. 523 (1943), and capitalization of depreciation to achieve such a result should not be required where it would conflict with the provisions of sections 167 and 263 and the principles of tax accounting for depreciation. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963).

Conclusion

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

FRANK NORTON KERN
LAWRENCE CHASE WILSON
Counsel for Respondent
Reid & Priest
40 Wall Street
New York, New York 10005

February 1974

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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IDAHO POWER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

1. In our opening brief, we demonstrated (Br. 8-15) that the deduction of construction-related depreciation claimed by respondent would result in a postponement in the recognition of income respondent has already earned. Respondent in effect concedes this but argues (Resp. Br. 7-16) that the concept of proper income accounting is irrelevant to tax depreciation. Underlying this argument are respondent's contentions that the purpose of the depreciation deduction allowed by Section 167 of the Internal Revenue Code of 1954, 26 U.S.C. 167, is the creation of a fund for the replacement of depreciable assets through the tax-free recovery of acquisition costs, and that the capitalization of construction-related depreciation is somehow incompatible with that purpose. Quite apart from the fact that its argument ignores the injunction of Section 446 of the Code that a taxpayer's accounting method must "clearly reflect income," respondent's contentions are premised upon three fundamental analytical errors.

First, although depreciation deductions do permit the tax-free recovery of acquisition costs, this is not primarily for the purpose of establishing a fund for the replacement of assets. Respondent's "replacement" theory was decisively rejected by this Court last Term in *United States* v. *Chicago, B. & Q. R. Co.*, 412 U.S. 401, 415:

> Whatever may be the desirability of creating a depreciation reserve under these circumstances, as a matter of good business and accounting practice, the answer is, as Judge Davis of the Court of Claims observed * * *, "Depreciation reflects the cost of an existing capital asset, not the cost of a potential replacement." * * *

Notwithstanding respondent's suggestions to the contrary (Resp. Br. 10-11), the accounting profession has also firmly rejected respondent's replacement theory of depreciation and has expressly determined instead that the purpose of depreciation is the proper allocation of historical costs to future periods, *i.e.*, the proper matching of expenses and revenues. See American Institute of Certified Public Accountants, *Accounting Research Bulletin No. 43* (1961). It is precisely that matching which we urge here.

Second, the very existence of depreciation as a tax concept illustrates that Congress was concerned with something more than mere tax-free recovery of acquisition costs. Depreciation deductions are not necessary to cost-recovery; more direct and efficacious provision for the recovery of costs could have been made by allowing an outright deduction for the cost of an asset in the year of acquisition. But Congress, aware that such a deduction would distort the reporting of income, chose to require "a meaningful allocation of [asset acquisition] cost to the tax periods benefited by the use of the asset." *Massey*

Motors v. *United States*, 364 U.S. 92, 96. It was for this allocative purpose, and this purpose only, that the concept of depreciation was necessary.

In other words, the guiding principle of tax depreciation is not cost-recovery as such but the recovery of costs over time through the proper matching of income and expenses.[1] The 1954 liberalization of tax depreciation allowances does not represent a departure from the principle of matching or from proper income accounting. It is a common view among accountants that "[a]ssets actually lose value in a manner that is best reported by the declining-balance method." Rothschild, *The Case for the Declining Balance*, 33 Taxes 503 (1955). It was for this reason that Congress expressly stated that in enacting liberalized depreciation allowances it was not "departing from realistic standards of depreciation accounting." H. Rep. No. 1337, 83d Cong., 2d Sess. 24.

Third, the capitalization of construction-related depreciation would not prevent respondent from fully recovering

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[1]Respondent, arguing that the matching of income and expenses has never been relevant to tax depreciation, erroneously cites (Resp. Br. 9, 38, 47) *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523, as holding that idle assets are subject to depreciation. The Court in that case in fact held only that depreciation is deductible in loss years, a holding which obviously conforms to the principle of matching. But the administratively convenient and generally accepted rule that idle assets held for use in business may be depreciated (see *e.g.*, *Carter-Colton Cigar Co. v. Commissioner*, 9 T.C. 219) is also consistent with that principle, for idle assets depreciate in value and such depreciation represents a decrease in the capital invested in the business which should be reflected in the reporting of income.

the costs it incurs in acquiring construction equipment.[2] Capitalization merely spreads the recovery of costs over the life of the newly constructed capital facility. Thus the only issue here is one of timing.

Respondent's contention is that cost-recovery should be achieved by the time the construction equipment itself has been fully exhausted. But the central point in this litigation is that the exhaustion of equipment used in a taxpayer's self-construction of assets does not represent a final disposition of the investment in that equipment; the investment in construction equipment becomes assimilated into the taxpayer's investment in the capital facility constructed with that equipment. It is appropriate therefore that construction equipment costs should be recovered only over the life of the capital facility.[3]

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[2]Some of respondent's equipment was used for both construction and maintenance. It is only the depreciation incurred in construction which we contend must be capitalized. But the allocation of depreciation between construction activities and maintenance activities is a simple accounting matter, similar to that of apportioning depreciation between business and nonbusiness uses. See, *e.g.*, *The Motel Co.* v. *Commissioner*, 340 F. 2d 445 (C.A. 2).

[3]In arguing the contrary, respondent relies upon *Massey Motors* v. *United States*, *supra*, and *United States* v. *Ludey*, 274 U.S. 295. But, as we have previously indicated, the Court in *Massey Motors* spoke in terms of "the tax periods benefited by the use of the asset" (364 U.S. at 96). See, also, *Hertz Corp.* v. *United States*, 364 U.S. 122, 126. The periods benefited by respondent's use of its construction equipment extend throughout the lives of the capital facilities which it constructs. And the Court in *Ludey* viewed (274 U.S. at 301) depreciation as representing the "gradual sale" of an asset as it is used up. The concept of a "sale" implies the final disposition of an investment. Respondent in constructing new facilities does not dispose of its investment in construction equipment; that investment simply becomes incorporated into the larger investments in the capital facilities themselves. Any "gradual sale" or disposition occurs only over the lives of those facilities.

The method of cost recovery which we urge harmonizes with the tax treatment accorded other costs of construction. For example, the cost of tools used up and discarded in the course of construction is also recoverable only over the life of the constructed facility. The same is true of the cost of construction materials and of wages paid to construction workers. Because all these costs are really only individual components of the capital investment in the constructed facility, they are properly recoverable only over that facility's life.[4] In advancing its theory of cost-recovery, respondent has shown no reason why its depreciation costs should uniquely be currently recoverable.

2. We showed in our opening brief (Br. 15-20) that Sections 161 and 263, read together, generally[5] require the capitalization of expenditures incurred in the acquisition of capital assets, even when those expenditures would othewise be deductible under Sections 162-188. To that showing, respondent appears to make three closely related responses, none of which has any merit.

Section 161 by its express terms makes Sections 162-188 subject to, *inter alia,* the capitalization requirement of Section 263. Respondent repeatedly attempts to dismiss Section 161 as a "housekeeping section" (Resp. Br. 22, 27). Although we have no principled

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[4]To the extent that the recovery of such component costs should be viewed as contributing to a "replacement" fund (see Resp. Br. 10-11), it is to a fund for the ultimate replacement of the capital facility, not for the immediate replacement of the separate items used up in its construction.

[5]Sections 263 and 266 explicitly exclude certain items from the requirement of capitalization.

objection to the term "housekeeping section," we believe the term "priority-ordering section" would be more accurate since the evident function of Section 161 is to specify those provisions of the Code which are to have priority in cases of conflict. Respondent's characterization of Section 161 as a "housekeeping section" does not deprive it of its priority-ordering force.[6]

Respondent also argues that since the government in this case has allowed the deduction of pension contributions and social security tax payments made on behalf of its construction workers, and of motor vehicle taxes incurred with respect to construction equipment, the question whether a construction cost "must be capitalized * * * turns on the intention of Congress as manifested in the provisions of the statute" (Resp. Br. 21). We agree. We pointed out in our opening brief (Br. 18) that taxes are specifically exempted by Section 266 from the requirement of capitalization; furthermore, pension contributions are made currently deductible by Section 404, which is not subject to the priority-ordering of Section 161.[7] No similar provision exempts respondent's

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[6]Respondent errs (Resp. Br. 26-27) concerning the origin of Section 161. That Section and Section 261 are the 1954 Code equivalents of the introductory phrases of Sections 23 and 24 of the 1939 Code which, taken together, served the same priority-ordering function. Section 261 now provides that "no deduction shall in any case be allowed in respect of the items [including capital expenditures] specified in this part." Thus the capitalization requirement of Section 263 would take precedence over the deductions permitted elsewhere even if Section 161 did not exist.

[7]Pension contributions made by a taxpayer on behalf of employees working on self-construction projects have long been considered currently deductible by the Internal Revenue Service. I.T. No. 3408, 1940-2 Cum. Bull. 178. We understand, however, that the scope of that ruling is presently under review. See note 6, *supra*.

construction-related depreciation from the requirement of capitalization.

Respondent further contends (Resp. Br. 19-21) that Section 263 and its predecessors have never been interpreted as requiring the capitalization of interest and taxes. But the cases upon which respondent relies involved taxes and interest payments in the nature of carrying charges. The courts concluded that since such carrying charges "do not improve the value of the property, but are payments necessary to the mere retention of ownership" (*Fraser* v. *Commissioner*, 25 F.2d 653, 654 (C.A. 2) (L. Hand, J.)), they could not properly be treated as capital items.[8] By contrast, the depreciation at issue in this case was incurred in the construction of capital facilities, *i.e.*, in "improv[ing] the value of [respondent's] property," and is therefore clearly a capital item. Thus the early cases holding that certain interest and tax payments were not capital in nature and therefore not capitalizable are simply not in point. The issue here is whether items which are clearly capital in nature must be capitalized.

3. We concluded our opening brief by showing (Br. 20-25) that construction-related depreciation is covered by the terms of Section 263. Respondent does not directly contest the validity of the Treasury Regulations which construe Section 263 as requiring capitalization of the "cost of acquisition, construction, or erection of buildings * * * and similar property * * *." 26 C.F.R. 1.263

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[8]The predecessor of Section 266, Section 130 of the Revenue Act of 1942, 56 Stat. 798, 827, was subsequently enacted in order to permit the capitalization of such carrying charges.

(a)-2(a). Nor does respondent directly deny that construction-related depreciation is an acquisition cost. Respondent nevertheless contends (Resp. Br. 32-47) that construction-related depreciation is not the kind of acquistion cost whose capitalization is contemplated by the statute.

In making this argument, respondent finds itself in flat disagreement with the Secretary's reading of the statute, for the Treasury Regulations require capitalization of the depreciation incurred in a taxpayer's self-construction of assets. A fair reading of the broad regulatory provisions promulgated by the Secretary with respect to Section 263 compels that conclusion. Moreover, the Secretary has indicated elsewhere that such depreciation is not deductible but must be "added to the basis of property being constructed, reconstructed, or erected by the taxpayer." 26 C.F.R. 1.48-1(b)(4). It is a familiar canon of statutory construction that "great deference [is owed] to the interpretation given the statute by the officers or agency charged with its administration." *Udall* v. *Tallman*, 380 U.S. 1, 16.

Respondent attempts to draw support for its construction of the statute from Sections 174, 182, 615, 616, and 617, which permit construction-related depreciation to be deducted in certain narrowly defined circumstances. Yet those provisions clearly demonstrate the unsoundness of respondent's position in this litigation. The purpose of each of those provisions is to permit a business taxpayer to deduct items which would otherwise be capital in nature; by expressly designating construction-related depreciation as a deductible expenditure for purposes of those provisions, Congress evidenced its awareness that such depreciation would otherwise have to be capitalized.

Section 182, for example, permits a taxpayer already engaged in the business of farming to deduct land-clearing expenditures, expressly including depreciation on the equipment used in clearing the land. If respondent's contention in this case were sound, such depreciation would have been deductible without regard to Section 182. A farmer's land-clearing equipment is used in his trade or business for purposes of the depreciation deduction under Section 167 in just the same way that respondent's construction equipment is used in its trade or business. See Resp. Br. 23-26. See, also, *Great Northern Railway Co.* v. *Commissioner*, 30 B.T.A. 691, 707-708.[9] Depreciation on land-clearing equipment was nevertheless "chargeable to [the] capital account" (Section 182(a)) prior to the enactment of Section 182 because it was capital in nature. In enacting Section 182, Congress extended to farmers the election of treating such depreciation as a currently deductible item not subject to the requirement of capitalization. Respondent has not been granted such an election with respect to its construction-related depreciation.

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[9]Respondent incorrectly describes (Resp. Br. 28, n. 13) *Great Northern Railway Co.* as holding that construction-related depreciation "was not to be capitalized." The Commissioner there had failed to argue that the depreciation was required to be capitalized under the predecessor of Section 263. As the court recognized (30 B.T.A. at 708), the only issue before it therefore was whether the equipment in question had been "used in the * * * trade or business" for purposes of the predecessor of Section 167. That issue concededly is not involved here. See. Br. 9; Resp. Br. 23-26. The issue here is the scope of the capitalization requirement of Section 263.

For the foregoing reasons, and for the reasons stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

KEITH A. JONES,
Assistant to the Solicitor General.

ELMER J. KELSEY,
MICHAEL L. PAUP,
Attorneys.

FEBRUARY 1974.

DOJ-1974-02

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Lumber Co.*, 200 U.S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

COMMISSIONER OF INTERNAL REVENUE *v.* IDAHO POWER CO.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 73-263. Argued February 27, 1974—Decided June 24, 1974

Section 167 (a) of the Internal Revenue Code of 1954 allows a depreciation deduction from gross income for "property used in the [taxpayer's] trade or business" or "held for the production of income," whereas § 263 (a) (1) of the Code disallows a deduction for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate," expenditures which, the regulations state, include the "cost of acquisition, construction, or erection of buildings." Section 161 makes the deductions specified in that part of the Code, including § 167 (a), subject to the exceptions provided in the part including § 263. Respondent public utility claimed a deduction from gross income under § 167 (a) for *all* the depreciation for the year on its transportation equipment (cars, trucks, etc.), including that portion attributable to its use in constructing capital facilities, although on its books, as required by the regulatory agencies, it charged such equipment, to the extent it was used in construction, to the capital assets so constructed. The Commissioner of Internal Revenue disallowed the deduction for the construction-related depreciation, ruling that depreciation was a nondeductible capital expenditure under § 263 (a). The Commissioner was upheld by the Tax Court, but the Court of Appeals reversed, holding that a deduction expressly enumerated in the Code, such as that for depreciation, may properly be taken even if it relates to a capital item, and that § 263 (a) (1) was inapplicable because depreciation is not an "amount paid out" as required by that section. *Held:* The equipment depreciation allocable to the taxpayer's construction of

capital facilities must be capitalized under § 263 (a)(1). Pp. 8–17.

(a) Accepted accounting practice and established tax principles require the capitalization of the cost of acquiring a capital asset, including the cost incurred in a taxpayer's construction of capital facilities. The purpose of depreciation accounting is the allocation of the expense of using an asset over the tax periods benefited by that asset. Pp. 8–11.

(b) Construction-related depreciation is not unlike expenditure for other construction-related items, such as construction workers' wages, which must be treated as part of the cost of acquiring a capital asset. The significant fact is that the exhaustion of the construction equipment does not represent the final disposition of the taxpayer's investment in that equipment; rather such investment is assimilated into the cost of the capital asset constructed, and this capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized. Pp. 11–12.

(c) Capitalization of construction-related equipment depreciation by the taxpayer which does its own construction work maintains tax parity with the taxpayer which has such work done independently. P. 12.

(d) Where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency *and* that method clearly reflects income, as here, it is almost presumptively controlling of federal income tax consequences. Pp. 12–13.

(e) Considering § 263 (a)'s literal language in denying a deduction for "[a]ny amount paid out" for construction or permanent improvement of facilities, and its purpose to reflect the basic principle that a capital expenditure may not be deducted from current income, as well as the regulations indicating that for purposes of § 263 (a) "amount paid out" equates with "cost incurred," there is no question that the cost of the transportation equipment was "paid out" in the same manner as the cost of other construction-related items, such as supplies, materials, and wages, which the taxpayer capitalized. Pp. 13–15.

(f) The priority-ordering directive of § 161 requires that § 263 (a)'s capitalization provision take precedence, on the facts, over § 167 (a). Pp. 15–17.

477 F. 2d 688, reversed.

Syllabus

BLACKMUN, J., delivered the opinion of the Court, in which BURGER, C. J., and BRENNAN, STEWART, WHITE, MARSHALL, POWELL, and REHNQUIST, JJ., joined. DOUGLAS, J., filed a dissenting opinion.

NOTICE: This opinion is subject to formal revision before publication in the preliminary print of the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D.C. 20543, of any typographical or other formal errors, in order that corrections may be made before the preliminary print goes to press.

SUPREME COURT OF THE UNITED STATES

No. 73-263

Commissioner of Internal Revenue, Petitioner, v. Idaho Power Company.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[June 24, 1974]

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

This case presents the sole issue whether, for federal income tax purposes, a taxpayer is entitled to a deduction from gross income, under § 167 (a) of the Internal Revenue Code of 1954, 26 U. S. C. § 167 (a),[1] for depreciation on equipment the taxpayer owns and uses in the construction of its own capital facilities, or whether the capitalization provision of § 263 (a) of the Code, 26 U. S. C. § 263 (a),[2] bars the deduction.

The taxpayer claimed the deduction, but the Commissioner of Internal Revenue disallowed it. The Tax Court

[1] "§ 167. Depreciation.

"(a) General rule.

"There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income."

[2] "§ 263. Capital expenditures.

"(a) General rule.

"No deduction shall be allowed for—

"(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

(Scott, J., in an opinion not reviewed by the full court) upheld the Commissioner's determination. 29 T. C. M. 383 (1970). The United States Court of Appeals for the Ninth Circuit, declining to follow a Court of Claims decision, *Southern Natural Gas Co.* v. *United States*, 188 Ct. Cl. 302, 372–380, 412 F. 2d 1222, 1264–1269 (1969), reversed. 477 F. 2d 688 (1973). We granted certiorari in order to resolve the apparent conflict between the Court of Claims and the Court of Appeals. 414 U. S. 999 (1973).

I

Nearly all the relevant facts are stipulated. The taxpayer-respondent, Idaho Power Company, is a Maine corporation organized in 1915, with its principal place of business at Boise, Idaho. It is a public utility engaged in the production, transmission, distribution, and sale of electric energy. The taxpayer keeps its books and files its federal income tax returns on the calendar year accrual basis. The tax years at issue are 1962 and 1963.

For many years, the taxpayer has used its own equipment and employees in the construction of improvements and additions to its capital facilities.[3] The major work has consisted of transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities.

During 1962 and 1963, the tax years in question, taxpayer owned and used in its business a wide variety of automotive transportation equipment, including passenger cars, trucks of all descriptions, power operated equipment, and trailers. Radio communication devices were affixed to the equipment and were used in its daily opera-

[3] For a period near the end of World War II, the taxpayer constructed all its capital improvements. At other times, outside contractors have performed part of this work. At the time of the trial of this tax case, the taxpayer had 140 employees engaged in new construction; it has had as many as 300 employees so engaged.

tions. The transportation equipment was used in part for operation and maintenance and in part for the construction of capital facilities having a useful life of more than one year.

On its books, the taxpayer used various methods of charging costs incurred in connection with its transportation equipment either to current expense or to capital accounts. To the extent the equipment was used in construction, the taxpayer charged depreciation of the equipment, as well as all operating and maintenance costs (other than pension contributions, social security and motor vehicle taxes) to the capital assets so constructed. This was done either directly or through clearing accounts in accordance with procedures prescribed by the Federal Power Commission and adopted by the Idaho Public Utilities Commission.

For federal income tax purposes, however, the taxpayer treated the depreciation on transportation equipment differently. It claimed as a deduction from gross income *all* the year's depreciation on such equipment, including that portion attributable to its use in constructing capital facilities. The depreciation was computed on a composite life of 10 years and under straight-line and declining balance methods. The other operating and maintenance costs the taxpayer had charged on its books to capital were not claimed as current expenses and were not deducted.

To summarize: On its books, in accordance with Federal Power Commission-Idaho Public Utilities Commission prescribed methods, the taxpayer capitalized the construction-related depreciation, but for income tax purposes that depreciation increment was claimed as a deduction under § 167 (a).[4]

[4] For 1962 and 1963 the taxpayer's gross construction additions were $8,235,440.22 and $5,988,139.56, respectively. Of these amounts, the taxpayer itself constructed $7,139,940.72 and $5,642,342.79. The

Upon audit, the Commissioner of Internal Revenue disallowed the deduction for the construction-related depreciation. He ruled that that depreciation was a nondeductible capital expenditure to which § 263 (a) had application. He added the amount of the depreciation so disallowed to the taxpayer's adjusted basis in its capital facilities, and then allowed a deduction for an appropriate amount of depreciation on the addition, computed over the useful life (30 years or more) of the property constructed. A deduction for depreciation of the transportation equipment to the extent of its use in day-to-day operation and maintenance was also allowed. The result of these adjustments was the disallowance of depreciation, as claimed by the taxpayer on its returns, in the net amounts of $140,429.75 and $96,811.95 for 1962 and 1963, respectively. This gave rise to asserted deficiencies in taxpayer's income taxes for those two years of $73,023.47 and $50,342.21.

The Tax Court agreed with the decision of the Court of Claims in *Southern Natural Gas*, *supra*, and described that holding as one to the effect that "depreciation allocable to the use of the equipment in the construction of capital improvements was not deductible in the year the equipment was so used but should be capitalized and recovered over the useful life of the assets constructed." 29 T. C. M., at 386. The Tax Court, accordingly, held that the Commissioner "properly disallowed as a deduction . . . this allocable portion of depreciation and that such amount should be capitalized as part of [taxpayer's]

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self-construction portion, therefore, obviously was a substantial part of the gross. The equipment depreciation for those years, to the extent allocated to use in construction and capitalized on the taxpayer's books, amounted to $150,047.42 and $130,523.99, respectively. These were the depreciation amounts deducted for income tax purposes, the major portions of which are presently at issue.

basis in the permanent improvements in the construction of which the equipment was used." *Ibid.*

The Court of Appeals, on the other hand, perceived in the Internal Revenue Code of 1954 the presence of a liberal congressional policy toward depreciation, the underlying theory of which is that capital assets used in business should not be exhausted without provision for replacement. 477 F. 2d, at 690–693. The court concluded that a deduction expressly enumerated in the Code, such as that for depreciation, may properly be taken and that "no exception is made should it relate to a capital item." *Id.*, at 693. Section 263 (a) of the Code was found not to be applicable because depreciation is not an "amount paid out," as required by that section. The court found *Southern Natural Gas* unpersuasive and felt "constrained to distinguish" it in reversing the Tax Court judgment. 477 F. 2d, at 695–696.

The taxpayer asserts that its transportation equipment is used in its "trade or business" and that depreciation thereon is therefore deductible under § 167 (a)(1) of the Code. The Commissioner concedes that § 167 may be said to have a literal application to depreciation on equipment used in capital construction,[3] Brief for Petitioner

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[3] For purposes of the issue here presented, the key phrase of § 167 (a) is "property used in the trade or business." Construction of this phrase in the present context has been infrequent and not consistent. In *Great Northern R. Co.* v. *Commissioner*, 40 F. 2d 372 (CA8), cert. denied, 282 U. S. 855 (1930), the court held that where a railroad transported men and equipment to a construction site, the depreciation of the train attributable to the construction work was to be capitalized. No consideration was given to whether the claimed deduction was available for property used in the taxpayer's trade or business. See also *Gulf, Mobile and Northern R. Co.* v. *Commissioner*, 22 B. T. A. 233, 245–247 (1931), aff'd as to other issues, 63 U. S. App. D. C. 244, 71 F. 2d 953 (1934), aff'd, 293 U. S. 295 (1934); *Missouri Pacific R. Co.* v. *Commissioner*, 22 B. T. A. 267,

16, but contends that the provision must be read in the light of § 263 (a)(1) which specifically disallows any deduction for an amount "paid out for new buildings or for

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286–287 (1931); *Northern Pacific R. Co.* v. *Helvering*, 83 F. 2d 508, 513 (CA8 1936).

In a subsequent case, *Great Northern R. Co.* v. *Commissioner*, 30 B. T. A. 691 (1934), the Board of Tax Appeals reached the contrary result on identical facts. The Board held that the train equipment, even though used in part for construction of branch lines of the railroad, was used in a trade or business, and that this satisfied the requirements of the statute. The depreciation, therefore, was held deductible. *Id.*, at 708. This appears to have been the prevailing view until the issuance of Rev. Rul. 59–380, 1959–2 C. B. 87, where it was stated:

"In the instant case the capital improvements constructed constitute property to be used in the trade or business or property held for the production of income. However, the building equipment used in the construction cannot be considered as property used in the regular trade or business of the taxpayer." *Id.*, at 88.

Rev. Rul. 58–380 was in part the basis for the holding of the Court of Claims in *Southern Natural Gas*, 188 Ct. Cl., at 378–379, 412 F. 2d, at 1268. The Court of Claims rejected the "a trade or business" approach in favor of the rule that, to be deductible from current income, depreciation must be of property used in *the* trade or business of the taxpayer. Equipment, to the extent used by the taxpayer in construction of additional facilities, was not used in *the* trade or business of the natural gas company. Thus, no depreciation deduction was allowable and the contested amount of depreciation was to be capitalized.

In the instant case, the Court of Appeals concluded that transportation equipment used by the taxpayer to construct its own capital improvements was used in the trade or business of the taxpayer:

"The continuity and regularity of taxpayer's construction activities, the number of employees engaged in construction and the amounts expended on construction all point to the conclusion that construction of facilities is a major aspect of the taxpayer's trade or business. These activities are auxiliary operations incident to the taxpayer's principal trade or business of producing, transmitting, distributing and

permanent improvements or betterments." He argues that § 263 takes precedence over § 167 by virtue of what he calls the "priority-ordering" terms (and what the taxpayer describes as "housekeeping" provisions) of § 161 of the Code, 26 U. S. C. § 161,[6] and that sound principles of accounting and taxation mandate the capitalization of this depreciation.

It is worth noting the various items that are not at issue here. The mathematics, as such, is not in dispute. The taxpayer has capitalized, as part of its cost of acquisition of capital assets, the operating and maintenance costs (other than depreciation, pension contributions, and social security and motor vehicle taxes) of the transportation equipment attributable to construction. This is not contested. The Commissioner does not dispute that the portion of the transportation equipment's depreciation allocable to operation and maintenance of facilities, in contrast with construction thereof, qualifies as a deduction from gross income. There is no disagreement as to the allocation of depreciation between construction and maintenance. The issue, thus comes down primarily to a question of timing, as the Court of

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selling electrical energy within the meaning of section 167." 477 F. 2d, at 696.

Since the Commissioner appears to have conceded the literal application of § 167 (a) to Idaho Power's equipment depreciation, we need not reach the issue whether the Court of Appeals has given the phrase "used in the trade or business" a proper construction. For purposes of this case, we assume, without deciding, that § 167 (a) does have a literal application to the depreciation of the taxpayer's transportation equipment used in the construction of its capital improvements.

[6] "§ 161. Allowance of deductions.

"In computing taxable income under section 63 (a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible)."

Appeals recognized, 477 F. 2d, at 692, that is, whether the construction-related depreciation is to be amortized and deducted over the *shorter* life of the equipment or, instead, is to be amortized and deducted over the *longer* life of the capital facilities constructed.

II

Our primary concern is with the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities. Over a period of time a capital asset is consumed and, correspondingly over that period, its theoretical value and utility are thereby reduced. Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted.[7] As the process of consumption continues, and depreciation is claimed and allowed, the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. The Court stated in *Hertz Corp.* v. *United States*, 364 U. S. 122, 126 (1960), "[T]he purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset." See also *United States* v. *Ludey*, 274 U. S. 295, 300–301 (1927); *Massey Motors, Inc.* v. *United States*, 364 U. S. 92, 96 (1960);

[7] The Committee on Terminology of the American Institute of Certified Public Accountants has discussed various definitions of depreciation and concluded that:

"These definitions view depreciation, broadly speaking, as describing not downward changes of value regardless of their causes but a money cost incident to exhaustion of usefulness. The term is sometimes applied to the exhaustion itself, but the committee considers it desirable to emphasize the cost concept as the primary if not the sole accounting meaning of the term: thus, *depreciation* means the cost of such exhaustion, as *wages* means the cost of labor" (emphasis in original). 2 APB Accounting Principles, Accounting Terminology Bulletin No. 1—Review and Resumé ¶ 48, p. 9512 (1973).

Fribourg Navigation Co. v. *Commissioner*, 383 U. S. 272, 276–277 (1966). When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate to the production of income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, the cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.

The Court of Appeals opined that the purpose of the depreciation allowance under the Code was to provide a means of cost recovery, *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, 13–14 (1909), and that this Court's decision's, *e. g.*, *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98, 101 (1943), endorse a theory of replacement through "a fund to restore the property." 477 F. 2d, at 691. Although tax-free replacement of a depreciating investment is one purpose of depreciation accounting, it alone does not require the result claimed by the taxpayer here. Only last Term, in *United States* v. *Chicago, Burlington & Quincy R. Co.*, 412 U. S. 401 (1973), we rejected replacement as the strict and sole purpose of depreciation:

> "Whatever may be the desirability of creating a depreciation reserve under these circumstances, as a matter of good business and accounting practice, the answer is . . . 'Depreciation reflects the cost of an existing capital asset, not the cost of a potential replacement.'" *Id.*, at 415.

Even were we to look to replacement, it is the replacement of the constructed facilities, not the equipment used to build them, with which we would be concerned. If the taxpayer now were to decide not to construct any more capital facilities with its own equipment and employees, it, in theory, would have no occasion to replace its equipment to the extent that it was consumed in prior construction.

Accepted accounting practice [8] and established tax principles require the capitalization of the cost of acquiring a capital asset. In *Woodward* v. *Commissioner*, 397 U. S. 572, 575 (1970), the Court observed, "It has long been recognized, as a general matter, that costs incurred in the acquisition . . . of a capital asset are to be treated as capital expenditures." This principle has obvious application to the acquisition of a capital asset by purchase, but it has been applied, as well, to the costs incurred in a taxpayer's construction of capital facilities. See, *e. g.*, *Southern Natural Gas Co.* v. *United States, supra; Great Northern R. Co.* v. *Commissioner*, 40 F. 2d 372 (CA8 1930), cert. denied, 382 U. S. 855 (1930); *Coors* v. *Commissioner*, 60 T. C. 368, 398 (1973); *Norfolk Shipbuilding & Drydock Corp.* v. *United States*, 321 F. Supp. 222 (ED Va. 1971); *Producers Chemical Co.* v. *Commissioner*, 50 T. C. 940 (1968); *Brooks* v. *Commissioner*, 50 T. C.

[8] The general proposition that good accounting practice requires capitalization of the cost of acquiring a capital asset is not seriously open to question. The Commissioner urges, however, that accounting methods as a rule require the treatment of construction-related depreciation of equipment as a capital cost of the facility constructed. Indeed, there is accounting authority for this. See, *e. g.*, W. Paton, Asset Accounting 188, 192–193 (1952); H. Finney and H. Miller, Principles of Accounting—Introductory 246–247 (6th ed. 1963) (depreciation as an expense should be matched with the production of income); W. Paton, Accountants' Handbook, 652 (3d ed. 1943); Note, 1973 Duke L. J. 1377, 1384; Note, 52 N. Car. L. Rev. 684, 692 (1974).

927, 935–936 (1968), rev'd on other grounds, 424 F. 2d 116 (CA5 1970).[8]

There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162 (a)(1) of the 1954 Code, 26 U. S. C. § 162 (a)(1). But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired. *Briarcliff Candy Corp.* v. *Commissioner*, 475 F. 2d 775, 781 (CA2 1973); *Perlmutter* v. *Commissioner*, 44 T. C. 382, 404 (1965), aff'd, 373 F. 2d 45 (CA10 1967); *Jaffa* v. *United States*, 198 F. Supp. 234, 236 (ND Ohio 1961). See Treas. Reg. § 1.266–1 (e).

Construction-related depreciation is not unlike expenditures for wages for construction workers. The significant fact is that the exhaustion of construction equipment does not represent the final disposition of the taxpayer's investment in that equipment; rather, the investment in the equipment is assimilated into the cost of the capital asset constructed. Construction-related depreciation on the equipment is not an expense to the taxpayer of its

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[8] Except for the Court of Appeals in the present case, the courts consistently have upheld the position of the Commissioner that construction-related depreciation is to be capitalized. *Great Northern R. Co.* v. *Commissioner*, 30 B. T. A. 691 (1934), upon which the Court of Appeals relied, is not to the contrary. In that case the Board concluded that construction-related depreciation was deductible under § 23 (*l*)(1) of the Internal Revenue Code of 1939 (the provision corresponding to § 167 (a)(1) of the 1954 Code). The Commissioner in that case, however, had not argued for the capitalization of construction-related depreciation. *Id.*, at 708.

day-to-day business. It is, however, appropriately recognized as a part of the taxpayer's cost or investment in the capital asset. The taxpayer's own accounting procedure reflects this treatment, for on its books the construction-related depreciation was capitalized by a credit to the equipment account and a debit to the capital facility account. By the same token, this capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized. See, *e. g.*, *Coors* v. *Commissioner*, 60 T. C., at 398; *Southern Natural Gas Co.* v. *United States*, 412 F. 2d, at 1265.

An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor's equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost, of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals holding would lead to disparate treatment among taxpayers because it would allow the firm with sufficient resources to construct its own facilities and to obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost including depreciation charged to it by the contractor.

Some, although not controlling, weight must be given to the fact that the Federal Power Commission and the Idaho Public Utilities Commission required the taxpayer to use accounting procedures that capitalized construction-related depreciation. Although agency-imposed compulsory accounting practices do not necessarily dictate tax consequences, *Old Colony R. Co.* v. *Commissioner*, 284

U. S. 552, 562 (1932), they are not irrelevant and may be accorded some significance. *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U. S. 345, 355–356 (1971). The opinions in *American Automobile Assn* v. *United States*, 367 U. S. 687 (1961), and *Schlude* v. *Commissioner*, 372 U. S. 128 (1963), urged upon us by the taxpayer here, are not to the contrary. In the former case it was observed that merely because the method of accounting a taxpayer employs is in accordance with generally accepted accounting procedures, this "is not to hold that for income tax purpose it so clearly reflects income as to be binding on the Treasury." 367 U. S., at 693. See also *Cincinnati, New Orleans & Texas Pac. R. Co.* v. *United States*, 191 Ct. Cl. 572, 583–584, 424 F. 2d 563, 570 (1970). Nonetheless, where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency *and* that method clearly reflects income,[10] it is almost presumptively controlling of federal income tax consequences.

The presence of § 263 (a) in the Code is of significance. Its literal language denies a deduction for "[a]ny amount paid out" for construction or permanent improvement of facilities. The taxpayer contends, and the Court of Appeals held, that depreciation of construction equip-

[10] Section 446 of the Code, 26 U. S. C. § 446, reads in part as follows:

"§ 446. General rule for methods of accounting.

"(a) General rule.

"Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) Exception.

"If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

ment represents merely a decrease in value and is not an amount "paid out," within the meaning of § 263 (a). We disagree.

The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing. The Regulations state that the capital expenditures to which § 263 (a) extends include the "cost of acquisition, construction, or erection of buildings." Treas. Reg. § 1.263 (a)–2 (a). This manifests an administrative understanding that for purposes of § 263 (a), "amount paid out" equates with "cost incurred." The Internal Revenue Service for some time has taken the position that construction-related depreciation is to be capitalized. Rev. Rul. 59–380, 1952–2 C. B. 87; Rev. Rul. 55–252, 1955–1 C. B. 319.

There is no question that the cost of the transportation equipment was "paid out" in the same manner as the cost of supplies, materials, and other equipment, and the wages of construction workers.[11] The taxpayer does not question the capitalization of these other items as elements of cost of acquiring a capital asset. We see no

[11] The taxpayer contends that depreciation has been held not to be an expenditure or payment for purposes of a charitable contribution under § 170 of the Code, 26 U. S. C. § 170, *e. g.*, *Orr* v. *United States*, 343 F. 2d 553 (CA5 1965); *Mitchell* v. *Commissioner*, 42 T. C. 953, 973–974 (1964), or for purposes of a medical expense deduction under § 213, 26 U. S. C. § 213, *e. g.*, *Gordon* v. *Commissioner*, 37 T. C. 986 (1962). Section 263 is concerned, however, with the capital nature of an expenditure and not with its timing, as are the phrases "payment . . . within the taxable year" or "paid during the taxable year," respectively used in §§ 170 and 213. The treatment of depreciation under those sections has no relevance to the issue of capitalization here. See, *e. g.*, *Producers Chemical Co.* v. *Commissioner*, 50 T. C., at 959.

reason to treat construction-related depreciation differently. In acquiring the transportation equipment, taxpayer "paid out" the equipment's purchase price; depreciation is simply the means of allocating the payment over the various accounting periods affected. As the Tax Court stated in *Brooks* v. *Commissioner*, 50 T. C., at 935, "depreciation—inasmuch as it represents a using up of capital—is as much an 'expenditure' as the using up of labor or other items of direct cost."

Finally, the priority-ordering directive of § 161—or, for that matter, § 261 of the Code, 26 U. S. C. § 261 [12]—requires that the capitalization provision of § 263 (a) take precedence, on the facts here, over § 167 (a). Section 161 provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are "subject to the exceptions provided in part IX." Part VI includes § 167 and Part IX includes § 263. The clear import of § 161 is that, with stated exceptions set forth either in § 263 itself or provided for elsewhere (as, for example, in § 404 relating to pension contributions), none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI.

The Court of Appeals concluded, without reference to § 161, that § 263 did not apply to a deduction, such as that for depreciation of property used in a trade or business, allowed by the Code even though incurred in the construction of capital assets.[13] We think that the court

[12] "§ 261. General rule for disallowance of deductions.

"In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part."

[13] The Court of Appeals relied on *All-Steel Equipment, Inc.* v. *Commissioner*, 54 T. C. 1749 (1970), reversed in part, 467 F. 2d 1184 (CA7 1972), in holding that § 263 was inapplicable to deductions specifically allowed by the Code. 477 F. 2d, at 693. In *All-Steel*,

erred in espousing so absolute a rule, and it obviously overlooked the contrary direction of § 161. To the extent that reliance was placed on the congressional intent, in the evolvement of the 1954 Code, to provide for "liberalization of depreciation," H. R. Rep. No. 1337, 83d Cong., 2d Sess., 22 (1954), that reliance is misplaced. The House Report also states that the depreciation provisions would "give the economy added stimulus and resilience without departing from realistic standards of depreciation accounting." *Id.*, at 24. To be sure, the 1954 Code provided for new and accelerated methods for depreciation, resulting in greater depreciation deductions currently available. These changes, however, relate primarily to computation of depreciation. Congress certainly did not intend that provisions for accelerated depreciation should be construed as enlarging the class of depreciable assets

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the Tax Court faced the question whether taxes, losses, and research and experimental expenses incurred in manufacturing inventory items were currently deductible and need not be capitalized. The Tax Court held that these items were deductible, and that the taxpayer's method of accounting did not clearly reflect income. The Court of Appeals, in contrast, held that certain repair expenses incurred in producing inventory could be deducted "only in the taxable year in which the manufactured goods to which the repairs relate are sold." 467 F. 2d, at 1186. We need not decide this issue, but we note that § 263 (a)(1)(B) excepts research and experimental expenditures from capitalization treatment, see *Snow* v. *Commissioner*, — U. S. — (1974), and that § 266 of the Code, 26 U. S. C. § 266, creates a further exception by providing taxpayers with an election between capitalization and deduction of certain taxes and carrying charges. The Tax Court, in discussing deductions for taxes, losses, and research and experimental expenditures, observed that "deductions expressly granted by statute are not to be deferred even though they relate to inventory or capital items." 54 T. C., at 1759. This statement, when out of context, is subject to overbroad interpretation and, as is evident from our holding in the present case, has decided limitations in application.

to which § 167 (a) has application or as lessening the reach of § 263 (a). See Note, 1973 Duke L. J., at 1386.

We hold that the equipment depreciation allocable to taxpayer's construction of capital facilities is to be capitalized.

The judgment of the Court of Appeals is reversed.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 73-263

Commissioner of Internal Revenue, Petitioner, *v.* Idaho Power Company.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[June 24, 1974]

MR. JUSTICE DOUGLAS, dissenting.

This Court has, to many, seemed particularly ill-equipped to resolve income tax disputes between the Commissioner and the taxpayers. The reasons are (1) that the field has become increasingly technical and complicated due to the expansions of the Code and the proliferation of decisions and, (2) that we seldom see enough of them to develop any expertise in the area. Indeed, we are called upon mostly to resolve conflicts between the Circuits which more providently should go to the Standing Committee of the Congress for resolution.

That was the sentiments behind *Dobson* v. *Commissioner*, 320 U. S. 489, written by Justice Jackson and enthusiastically promoted by Justice Black, Justice Frankfurter, and myself. *Dobson*, save for egregious error and constitutional questions, would have left picayune cases such as the present one largely to the Tax Court, whose expertise is well recognized. But *Dobson* was short-lived, as Congress made clear its purpose that we were to continue on our leaden-footed pursuit of law and justice in this field. 62 Stat. 991.

Now that we are on our own I disagree with the Court in disallowing the present claim for depreciation. A company truck has, let us say, a life of 10 years. If it cost $10,000, one would expect that "a reasonable allow-

ance for the exhaustion, wear, and tear" of the truck would be $1,000 a year within the meaning of 26 U. S. C. § 167 (a). That was the provision in the House Report of the 1954 Code when it said that it provided for "a liberalization of depreciation with respect to both the estimate of useful life of property and the method of allocating depreciable cost over the years of service."[1] H. R. Rep. No. 1337, 83d Cong., 2d Sess., p. 22.

Not so, says the Government. Since the truck was used to build a plant for the taxpayer and the plant has a useful life of 40 years, a lower rate of depreciation must be used—a rate that would spread out the life of the truck for 40 years even though it would not last

[1] The Committee indicated that "reasonable" depreciation allowances include the straight-line method, the declining-balance method, or any other method that on an annual basis does not exceed the allowances on the declining-balance method. H. R. Rep. No. 1337, *supra*, pp. 22–23.

The purpose of providing more liberal depreciation allowances was explicitly stated:

"More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living.

"Small business and farmers particularly have a vital stake in a more liberal and constructive depreciation policy. They are especially dependent on their current earnings or short-term loans to obtain funds for expansion. The faster recovery of capital investment provided by this bill will permit them to secure short-term loans which would otherwise not be available." *Id.*, at 24.

more than 10. Section 167 provides for a depreciation deduction with respect to property "used in the (taxpayer's) trade or business" or "held for the production of income" by the taxpayer. There is no intimation that § 167 is not satisfied. The argument is rested upon § 161 which allows the deductions specified in § 163 (a) "subject to the exceptions" in § 263 (a) which provides:

> "No deduction shall be allowed for—
>
> "(1) Any amount paid out for new buildings or for permanent improvements or or betterments made to increase the value of any property or estate . . . ." U. S. Br., p. 2.

I agree with the Court of Appeals that depreciation claimed on a truck whose useful life is 10 years is not an amount "paid out" within the meaning of § 263 (a). If "payment" in the settling of § 263 (a) is to be read as including depreciation, Congress not the courts should make the decision.

I suspect that if the life of the vehicle were 40 years and the life of the building were 10 years IRS would be here arguing persuasively that depreciation of the vehicle should be taken over a 40 year period. That is not to impugn the integrity of IRS. It is only an illustration of the capricious character of how law is construed to get from the taxpayer the greatest possible return that is permissible under the Code.

The opinion of the Court of Appeals written by Judge Trask and concurred in by Choy and McGovern, Circuit Judges, states my view of the law.

Depreciation on an automobile is not allowed as a charitable deduction, *Orr* v. *United States*, 343 F. 2d 553, since it is not a "payment" within the meaning of § 170 (a)(1). Likewise depreciation on an automobile used to transport the taxpayer's son to a doctor is not

deductible as a medical expense under § 213 because it is not an expense "paid" within the meaning of the section. *Maurice S. Gordon*, 37 T. C. 986, *Calafut* v. *Commissioner*, 23 T. C. M. 1431 (1964). Under the same rationale charitable deductions for depreciation have not been allowed, *Orr* v. *United States*, 343 F. 2d 553 (CA5 1965); *Clinton H. Mitchell*, 43 T. C. 953, 973–974.[2]

IRS, however, has ruled that depreciation on construction equipment owned by a taxpayer and used in its construction work must be capitalized.[3] That revenue ruling, as the Court of Appeals held, is a legal opinion within the agency not a Regulation or Treasury decision. It is without force when it conflicts with an Act of Congress.[4] See *Bartels* v. *Burmingham*, 332 U. S. 126, 132.

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[2] Where Congress has intended that depreciation be treated as an expenditure it has stated that explicitly, *e. g.*, § 615 (a) of the Internal Revenue Code.

[3] Rev. Ruling 59–380, 1959–2 Cumm. Bul. 87:

"Depreciation sustained on construction equipment owned by a taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to and made a part of the cost of the capital improvements. So much thereof as is applicable to the cost of depreciable capital improvements is recoverable through deductions for depreciation over the useful life of such capital improvements.

"In the instant case the capital improvements constructed constitute property to be used in the trade or business or property held for the production of income. However, the building equipment used in the construction cannot be considered as property used in the regular trade or business of the taxpayer."

[4] "Departmental rulings not promulgated by the Secretary are of little aid in interpreting a tax statute . . .", *Biddle* v. *Commissioner*, 302 U. S. 573, 582. Indeed, each issue of the Internal Revenue Bulletin warns that "Revenue Rulings reported in the Bulletin do not have the force and effect of Treasury Department Regulations. . . ."

If the test under § 263(a) were the cost of capital improvements, the result would be different. But, as noted, the test is "any amount paid out," which certainly does not describe depreciation deductions unless words are to acquire esoteric meanings merely to accommodate IRS. Congress is the lawmaker: and taking the law from it, we should affirm the Court of Appeals.